

LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

Summary of Responses to the Directorate-General Internal Market and Services' Second Consultation

1. INTRODUCTION

In response to the second public consultation on the "Legislation on Legal Certainty of Securities Holding and Dispositions" held from 5.11.2010 till 21.01.2011, the Commission received 108 contributions from stakeholders: 53 from registered organisations¹, 40 from individuals² and 15 from public authorities. All but 2 responses (following requests from the contributors) are published on the EU Commission's website³.

The respondents⁴ consist of 35 intermediaries, 30 issuers and professional investors⁵, 13 trade and post-trade infrastructure providers, 15 other professions (academics, practitioners, international organisations etc.) and 15 public authorities (see the attached annex for the full list of respondents and the abbreviations used). Only two contributions were submitted by non-professionals - a consumer association and a trade union organisation. However, none were received from individuals acting either as citizens or as retail investors.

Of course, these categories are not always clear-cut since, for example, many intermediaries can be at the same time issuers and/or investors. Issuers and investors are often symmetrically opposed in other contexts, such as corporate law. However, in the present context of book-entry securities, these categories help to identify the major groups of respondents, with quite a strong correlation between their main activity and the concerns expressed in their respective answers.

¹ Registered on the Register of interest representatives: <https://webgate.ec.europa.eu/transparency/regrin/welcome.do>

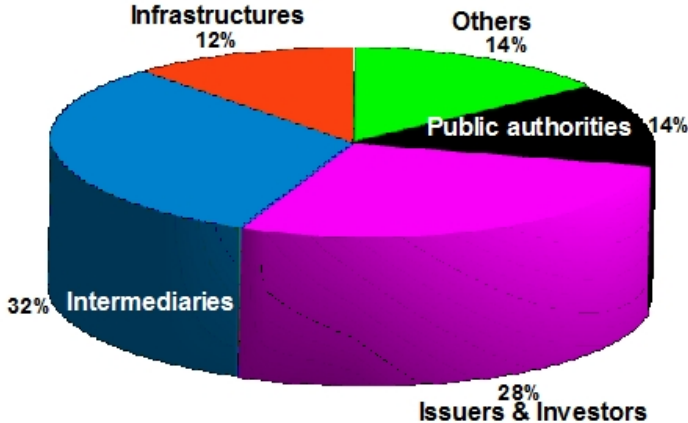
² "Individuals" referred here are private organisations who failed to register, whose answers are therefore assumed having been sent by the individual who signed it and not by their respective organization. They should therefore not be confused with natural persons acting as investors or EU citizens.

³ http://ec.europa.eu/internal_market/consultations/2010/securities_en.htm

⁴ We classified associations by who they represent.

⁵ Issuers and professional investors were counted together since most professional investors that answered could also be counted at the same time as issuers (mostly from the insurance sector).

Figure 1



The geographical distribution of the respondents is based on the address provided with their response. This is why some of the respondents are labelled as coming from outside the EU, even though some of their activities are partly located within the EU. Associations with an obviously European-wide representation were included in the "EU" category. As can be seen in the table below, the responses do not cover all EU15 Member States. Nearly half of the responses came from EU12 Member States while 5 contributions came from international bodies and 2 from the USA.

Figure 2

Austria	4	Netherlands	3
Belgium	2	Poland	1
Bulgaria	1	Portugal	1
Denmark	2	Romania	1
Estonia	1	Spain	1
Finland	2	Sweden	4
France	23	UK	18
Germany	17	Respondents covering EU	12
Greece	1	EEA (Norway)	1
Hungary	1	USA	2
Italy	4	International associations/organisations	5
Luxembourg	1		

In the analysis below, each respondent is counted individually, although there are some similar responses or common identities evident. Some contributions addressed the questionnaire only partially or in general terms. In such cases their positions, when expressed, were reflected in the statistics, while blank answers were counted as "no answer".

2. EXECUTIVE SUMMARY

The initiative was welcomed by almost all respondents, who confirmed problems caused by the absence of a harmonised legal framework in at least one of the four areas covered by the consultation. However, there was considerable divergence in views as to how to tackle each of the relevant areas.

2.1 Holding and disposition of book-entry securities (Principles 1 to 13)

Compared to the first consultation, it appears that most stakeholders agree with the functional approach. For instance, the division between the "rights on the securities" and the "rights flowing from the securities", which was reflected in the first two chapters of the draft consultation, now seem widely accepted.

More particularly, there was an agreement that the functional approach should not prevent the envisaged legislation from **making a clear distinction within a holding chain between the securities accounts that serve for the "holding of securities" and the securities accounts that serve for the "maintaining of records"**. In particular, the constitution of collateral and of attachments should only occur on the former. However, the place within the text where this distinction could be reflected was not clear.

Similarly, most stakeholders agreed that in accordance with the functional approach the envisaged legislation should refrain from characterising the "legal nature" of the book-entries. However, this should not prevent the characterising of the "economic nature" of the book-entries.

Articles 11 and 12 of the Geneva Securities Convention **distinguished between book-entries used for "acquisition and disposition of securities" and book-entries used for the "granting of interests"**. Some supporters of the Geneva Securities Convention suggested that this distinction could be better reflected in Principle 4 of the envisaged legislation. This may address the concerns of those who fear that the term "account held securities" could transform normal securities into a mere contractual bundle of rights.

There was also agreement that the identification of the relevant securities account for the "holding of securities" was determined by the position of the "ultimate account holder" or any equivalent term.

With regard to the enforceability of the book entries (Principles 5 and 6), most stakeholders agreed that a clear-cut "effectiveness" should prevail over particular national rules, and that a book-entry should be effective at least in the case of the insolvency of the account provider. There was similar agreement on the prohibition of attachments on accounts where book-entries reflect only the maintaining of records.

However, there were still three clear different preferences between stakeholders:

The use of the term "ultimate account holder"

Some supporters of the Geneva Securities Convention preferred referring to the "ultimate account holder" as "account holder who is not acting as account provider of someone else", whereas other respondents preferred using the terms "legal holder" (as in the Shareholders' Rights Directive) or even the term "investor".

It seems that the point of view of both groups is correlated to the national system of identification of shareholders. In that respect, we can draw a line between those countries that have developed a centralised registration system of shareholders distinct from the securities account systems (UK, Spain, Scandinavian countries) and other countries, where the securities account system contributed to the identification of the shareholders (DE, FR, IT, PT, etc).

Although this issue is specific to shares and does not address bonds, it explains the strong mobilization of issuers and investors in the latter countries that are concerned that the envisaged legislation compromises the identification of shareholders. This concern was also reflected by non-EU investors, who were keen on maintaining contacts with the European issuers.

Control of the integrity of the book-entry system

Supporters of a strong compatibility with Article 24 of the Geneva Securities Convention preferred that the "integrity rule" provided under Principle 4 was limited to the principle of static equivalence between securities maintained and securities held at the upper level, leaving to Member States the choice of the corrective measures to be implemented in case of shortfalls (reversals, buy ins or even pro-rata reduction).

On the other hand, some supporters of an "added value SLD" preferred that the "integrity rule" were completed with a dynamic system of reconciliation ideally performed under the control of the relevant Central Securities Depository (CSD), which linked this issue with the current public consultation on CSDs (closing date: 1.03.2011).

Control agreements and the hierarchy of book-entries

Two equal camps were identified: supporters of affording an inferior priority to interests created under a control agreement; and supporters of parity between methods of acquiring an interest in securities.

The former wanted to see control agreements accorded an inferior priority because they were not visible in the account or to investigation by third parties, whereas the latter contested that control agreements were less transparent than earmarking, while UK respondents in particular asserted that the reasons for justifying the effective abolishment of the control agreement were insufficient in the context of their essential role in providing liquidity to the UK's financial markets.

2.2 Conflict of laws rule (Principle 14)

There was widespread support for the envisaged legislation on substantive law issues to be supplemented with a conflict of laws rule. It was reiterated that both regimes were heavily interconnected due to the fact that the marketplace for account-held securities and for secured credit was a cross-border one.

When focusing on the connecting factor, a few respondents, (mostly issuers and investors), argued that the law governing substantial rights should be the law of the issuer, whereas some Infrastructure providers and intermediaries preferred that the law be defined contractually by the account provider and account holder (the Hague Securities Convention approach).

The majority were in favour of "**PRIMA**" (Place of Relevant Intermediary Approach), i.e. to submit matters arising in relation to account-held securities to the law of the country where the relevant securities account was maintained by the account provider. Although some respondents remained doubtful whether it was possible to identify the relevant account with sufficient certainty, others submitted constructive proposals on how to tackle this challenge.

2.3 Processing of rights flowing from securities (Principles 15 to 20)

There was agreement that significant problems regarding the cross-border exercise of rights attached to securities, (mostly voting rights), occurred in the internal market. Against this background there was widespread support for the introduction of provisions into the envisaged legislation which would oblige account providers to assist investors in the exercise of their rights. However, the answers provided a mixed picture on the degree of the obligations imposed and the sharing of costs:

Most contributors acknowledged that it was appropriate to provide a **duty for account providers to pass on information**, but at the same time it was felt that this duty should be strictly kept to what was necessary. However, it was felt that the envisaged Principle 16 did not give account providers enough guidance as to the extent of their obligations, i.e. which information should be passed, in what time and who would pay for it.

Principle 17, which aims at **facilitating the cross-border exercise of rights** attached to securities by the ultimate account holder received two types of response. The first two methods of facilitation received nearly unanimous support; however the third method, under which the account provider was required to provide evidence of the holdings of the ultimate account, faced strong opposition.

It was pointed out that the roots of the problem that Principle 17.2.c attempts to tackle lie in the respective national company laws, and that the envisaged legislation should respect its own principle not to harmonise the legal framework governing the question whom an issuer has to recognise as legal holder of its securities.

The proposal to **prevent cost discrimination of cross-border holdings as opposed to purely domestic holdings** experienced strong resistance from intermediaries and Infrastructure providers.

It was regarded as evident that the longer the intermediary chain was, the higher the costs of the exercise of rights attached to securities would be. It was felt that the reference to the Single Euro Payments Area (SEPA) was misleading as the processing of cross-border rights is more complex than the processing of payment instructions.

Furthermore, Principle 18 was expected to create one of two unintended situations:

1. Rather than lowering cross-border fees, account providers would raise their domestic fees instead to the level of those for cross-border services, or;
2. Account providers would withdraw from providing cross-border services. However, the discussion also showed that the transparency of the pricing of cross-border services could be improved.

2.4 Regulation of account providers (Principle 21)

There was general agreement on introducing a rule submitting all account providers to authorisation by a relevant supervisory authority. Most respondents agreed on the proposal to require account providers to obtain authorisation under Article 5 of the Markets in Financial Instruments Directive (MiFID), although some questioned whether Central Securities Depositories (CSDs) should be submitted to MiFID authorisation as they would be covered by the envisaged CSD legislation. Concerns were also raised about the proposal to convert account provision from an "ancillary service" to a full MiFID "investment service".

2.5 Definitions (Principle 22)

The general response was that the use of definitions largely facilitated the understanding of the scope and of the nature of the Principles. Some detailed comments were made on a number of terms proposed in the glossary, mainly on the notions "securities" and "account provider." The addition of new definitions was also suggested, e.g. "maintains securities accounts" as distinct from "safekeeping functions."

3. DETAILED ANALYSIS

3.1 Principle 1

1 – Objectives

- 1. EU law should regulate the legal framework governing the holding and disposition of securities held through securities accounts and the processing of rights flowing from securities held through securities accounts.*
- 2. The legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities.*

3.1.1 Question

Q1: Do you agree that the envisaged legislation should cover the objectives described above? If not, please explain why. Are any aspects missing (please consider also the following pages for a detailed description of the content of the proposal)?

3.1.2 Statistical Response

	Strongly support	Qualified support	Neutral	Qualified against	Strongly against	No answer
Paragraph 1 on Scope						
MiFID authorisation	5	4	46	9	0	44
Conflict of laws	4	7	32	23	0	42
Harmonisation of substantive law	10	17	12	21	13	35
Exercise of investors rights	6	15	16	34	0	37
Paragraph 2 on neutrality towards company law						
	9	18	13	18	16	31

3.1.3 Synthesis

95 stakeholders responded to this question. Most respondents rather presented a general and heterogeneous statement towards the envisaged legislation than providing a clear position to question 1. This makes it impossible to reflect the responses without generalisation. The table above aims to provide a quick overview

about the distribution of opinions in terms of prioritising the four objectives presented in the consultation paper.

The basic underlying of the envisaged legislation, the "functional approach", received a mixed response. Most stakeholders supported it explicitly and stressed that they preferred it to be without any major effects on national legislation (WKO, Pöch, OeKB, DE, DBB, UK, NL, GC100, KAS Bank, AFME, EAPB, and ESBG).

At the other end of the spectrum there were voices saying that "*if the functional approach is retained, it should be far more ambitious*". They agreed that ownership law should remain national, however the envisaged legislation was the right place to determine whether a person in the chain had proprietary rights in the securities and to ascertain on which account a proprietary right existed (French intermediaries).

A few claimed that the functional approach was "*an erroneous approach*" and that a legal definition of the ownership of securities was necessary (French academics, Eurostock).

Others, although supportive of the current approach of the project, considered that if the functional provisions would prove incapable of delivering the needed efficiency, the necessity of regulating Member States' corporate laws in order to guarantee the investors full rights could not be excluded (NO, BE)

As regards the geographical distribution of views one may note the following:

Most **UK stakeholders** (UK, FMLC, GVT, LSEG, CR, Pinsent, CLLS-CLC, issuers and investors) were supportive of the project to harmonise substantial law (objective 3), provided it delivered an internationally compatible legal framework, and were less enthusiastic about the project to harmonise the exercise of rights flowing from securities (objective 4).

Against this background CLLS-FLC diverged from other UK stakeholders insofar as it stressed its concern that the envisaged legislation did not cater properly for direct holding/transparent systems due to a lack of distinction between accounts that serve for the holding of securities and accounts that serve for maintaining records.

As regards conflict of laws (objective 2) UK respondents were in favour of adopting the Hague Securities Convention, whereas CLLS-FLC was also supportive of the

solution provided by Principle 14.2, if the communication were legally binding and enforced by a clear responsibility of the account provider in case of wrongful communication.

In terms of submitting all account providers to authorization and supervision (objective 1) CLLS-FLC provided detailed arguments against the use of MiFID to authorise to certain types of account providers such as trustees, agents of the issuers and CSDs.

Scandinavian stakeholders voiced their general support for the envisaged legislation (SE, FI, VP, SSDA, NFU, and NSA). However, Swedish stakeholders in particular pointed out that objective 4 could only facilitate, but not guarantee the full exercise of investor rights without some harmonisation of whom the issuer has to recognise as the legitimate person.

The Finnish authorities agreed, insisting that the, account provider and account holder should define the way corporate actions should be handled.

Contrary to this, the Norwegian authorities believed that the necessity of regulating Member States' corporate laws in order to guarantee the investors full rights could not be excluded (NO).

Belgian stakeholders were in favour of the four objectives, Fortis stressed the need to bring the envisaged legislation in line with the existing *aquis communautaire*. Although supportive of the current approach of the project, Belgium considered that "*if functional provisions would not be capable of delivering the needed efficiency, the legislator of the EU could reconsider the current stance of neutrality vis-à-vis corporate law and envisage a harmonized recognition of the ultimate account holder as legal holder as a last resort*".

Luxembourg's ABBL backed the four objectives as well, but expressed doubt as to how an EU regime would work in relation to securities that are not issued by European entities.

Austrian respondents stressed the necessity of limiting the envisaged legislation to a functional, but minimum approach, (i.e. not encroaching on ownership law).

Also in this vein **Dutch contributors** (KAS Bank) supported a functional approach that did not aim at either reconstruction or fundamental change to national ownership concepts or rules of national company law (NL), or even considered that “*the scope of this legislation is too broad*”, especially in relation to objective 4 (DACSI).

Most **German respondents** stressed the high level of investor protection and system integrity currently available in Germany, which they did not wish to see decreased by harmonisation.

They supported a functional approach that was neutral and did not force Member States to give up their tried and tested legal principles (DE, DBB, VZBV, DAI-GDV-BDI, 10 issuers and investors).

At the same time they doubted whether the envisaged legislation was necessary, e.g. DE -“*The explanations according to which the various legal systems identify different ‘owners’ of the same security and cross-border securities transactions in the EU suffer from legal uncertainty and ineffectiveness – do not appear correct*”.

Concerns were also raised as to whether the project would fall short of investor protection and system integrity in comparison to the currently existing systems based on ownership.

German intermediaries represented by ZKA accepted objective 3 on harmonising substantial rights but voiced their resistance to objective 4 concerning corporate actions, as they claimed that the solution was not legal but technical (standardisation).

German foreign banks (VAB) feared that national systems, where intermediary depositaries did not acquire ownership but only possession rights, would be replaced by a system where ownership was acquired at each level of the holding chain via constitutive bookings. It recommended providing a distinction between title transfers and non-title transfers based on the Financial Collateral Directive.

It also recommended referring to the definition of the “legal owner” of the Shareholders Rights Directive.

At the other end of the spectrum was Clearstream, made conspicuous by its positive attitude towards the project, *“We share the view that a long-term harmonisation within the European Union would also improve the financial stability and would strengthen the financial markets in Europe”* and stressing the need for consistency with other EU directives.

The **French authorities** supported the four objectives and suggested adding a fifth one regarding the integrity of the issue in order to avoid any inflation of securities leading to a number of securities in circulation superior to the number of securities issued by the issuer.

Although French academics underlined that it was impossible to harmonise substantial rights without harmonising their legal nature, the other French stakeholders (intermediaries, issuers and investors) agreed that the future legislation should not try to characterise the nature of the ownership but it should state that a person in the chain had proprietary rights in the securities and determine the account on which a proprietary right existed.

They insisted that the terminology used for the beneficiaries of substantial rights should provide for a distinction between "investor", "legal holder" and "legal owner". They also wished to determine which accounts allowed for the exercise of substantial rights (the accounts held by the investor or their mandated agents), and which accounts allowed for the exercise of corporate rights (the account hold by the legal holder and/or the legal owner).

Great importance was also attached to the compatibility with the terminology applied by the Financial Collateral Directive. It was stressed that a cumbersome "Investor Compensation Scheme Directive" could be avoided if the right to rivindicate securities was better recognised by the envisaged legislation.

Overall, **Italian stakeholders** were in favour of the policies underpinning the Principles, but voiced their concerns about the practical development of objective 2 (ABI), objective 1 and 4 (Unicredit).

From the **Spanish side**, BME was supportive of the project based on a functional approach, but noted that the wording of Principle 1.1 seemed to be too broad.

Most **stakeholders from the EU12** did not take a stand on the general objectives of the envisaged legislation, with the exception of the Romanian CSD, which expressly accepted them.

European intermediaries associations, which had the difficult task of synthesising the positions of the diverse banking communities, presented diverging views.

The EBF, AFME and EACB responded that the four objectives appeared legitimate and generally agreed with the envisaged legislation as outlined in the Consultation Paper.

However, the EBF found that objective 4 was formulated too broadly. Both the EBF and AFME stressed the need for alignment with other EU directives, while the EBF also highlighted the need to comply with the Geneva Securities Convention and build on the Market Standards for General Meetings (MSGM).

The EACB argued that the envisaged legislation should stress that only the ultimate account holder was entitled to exercise the rights *on the securities* and rights *flowing from the securities* and that he should have the direct right to do so in all jurisdictions.

At the other end of the spectrum were the ESBG and EAPB, who could not see the need for the envisaged legislation: “*The Commission’s proposals by far and large reflect today’s legislation and practice, hence it is difficult to see which value they would add*” (ESBG), “*European regulation of cross-border recognition of rights attached to securities was not necessary*” (EAPB).

As for **European Infrastructure Providers**, ECSDA provided no answer to question 1, but Euroclear stressed that Principle 1.1 was too broad and that the envisaged legislation should only focus on the legal difficulties associated with cross-border securities holdings and dispositions. Euroclear also observed that Principle 1.2 was undermined by the effect of other Principles which impacted the corporate laws of some Member States.

European issuers’ and investors’ associations also lacked a uniform position. While the ESH and ABI-Eumedion-Eurosif were supportive of the envisaged

legislation, European Issuers stated that: *“Notwithstanding the good intents of the European Commission, we are not convinced that there is a need for such a Directive as it stands”*. It feared that by using the concept of an “account holder,” European investors rights could be damaged because “account holder” might be interpreted as conferring rights attached to securities upon every intermediary in the chain, as happens in the USA.

Third country respondents responded positively to the envisaged legislation, stressing the need for global compatibility with the Geneva Securities Convention (AGC, ISDA, Computershare) and commenting on possible interactions with the conflict of laws solution envisaged in Principle 14 (AGC, ISDA).

The following aspects were identified as absent from the envisaged legislation:

- The absence of alignment with **existing EU legislation** - some stakeholders asserted that the envisaged legislation did not sufficiently take into account the existence of the **Financial Collateral Directive**, which had already achieved a harmonisation of the methods of taking collateral by distinguishing "title transfer collateral" and "security collateral" (French intermediaries, German issuers and investors). Furthermore, the principles lack alignment with the **Shareholders Rights Directive**, which determined that "shareholder" meant "the natural or legal person that is recognized as a shareholder under the applicable law". These stakeholders argued for using this method for all types of securities.
- Lack of coherence with Article 9.2.b., Article 10.2 and Article 28 of the **Geneva Securities Convention** (CLLS-FLC).
- Lack of **distinction** between **securities accounts** which had legal effects specified in the Principles **and other records relating to securities** (ISLA). This position was also echoed by the EACB, who asked for a distinction between the account relationship at the level of the ultimate account holder and the upper tier relationships. They proposed that it should be made clear that only the first relationship gave rise to the exercise of rights flowing from securities.
- Lack of recognition of **different account provider models**, which in the UK's SSS could create the risk that the obligations imposed by the envisaged legislation in relation to “ultimate account holders” would fall upon the issuer of

securities because the relevant account provider (CREST) did not “hold” any securities (CLLS-FLC).

- Opinions differed on the question whether the envisaged legislation should cover *"the functions of **creation, recording or reconciliation of securities**, by a person such as a central securities depository, central bank, transfer agent or registrar"*. Some contributors argued that this would be an important deficiency in terms of integrity of the issue which was allegedly inappropriately incited by Art. 6 of the Geneva Securities Convention (French intermediaries, AFME). One Member State wished to clarify in the envisaged legislation how a given security came into existence and was transferred to a central securities depository (HU). However, the majority of respondents felt that legal issues regarding creation of securities should be left to national law (DE, UK, NO, ZKA, Equiniti, IMA, EAPB, Computershare).
- Because the **issuers are not within the scope** of the envisaged legislation, it was disputed that the legislation could improve the *"cross-border recognition of rights attached to securities"* (ESBG, ZKA, and UniCredit).
- EU law should ensure that national **shareholder identification systems** could be enforced effectively across borders (DAI-GDV-BDI).
- Several stakeholders found that the **integrity of the issue** was not sufficiently addressed. French authorities suggested including this as a fifth objective by adding a new paragraph to Principle 1 *"EU law should guarantee the integrity of issuance in order to avoid any inflation of securities leading to a number of securities in circulation superior to the number of securities issued by the issuer"*. Several contributors claimed that the best method to guarantee the integrity of the issue was to introduce the **"no debit without credit rule"**, i.e. to provide that no crediting of an account could occur without the debiting of the account of the account provider of the disposer (DE, German issuers and investors, VZBV). Dynamic integrity methods were identified as absent by EuropeanIssuers who argued that the envisaged legislation must provide for **regular reconciliation**. German issuers and investors argued for the establishment of a **notary function**, i.e. providing for a person who safeguards that the issue is always 100% recorded.
- **Basic custody duties** were identified as missing by French authorities who suggested redrafting of Principle 1 by adding a 2nd paragraph that: *"EU law should*

regulate the basic custody service offered by the account provider to account holders in order to allow the processing of rights flowing from securities accounts and to guarantee the full exercise of rights by the account holders". German issuers/investors and French intermediaries also regretted the absence of a clear and straightforward enumeration of account providers' duties.

- Principles stated in **ESCB/CESR regarding Delivery vs. Payment (DVP) and reversals** should be built into the legislation.
- The establishment of **cross-border dispute resolution procedures** was proposed by NFU.

3.2 Principle 2

2 – Shared Functions

1. *It should be possible for Member States to provide that a person other than the account provider is responsible for the performance of certain, but not all, functions of an account provider. In such a case, references made in EU law to an account provider aim at the person responsible for performing the function to which the relevant provision applies.*

2. *The Commission would need to be notified accordingly and could specify the exact content of the notification. The Commission should publish on its website a list of Member States allowing for the sharing of account-provider functions, including all relevant specifications.*

3.2.1.1 Questions

Q2: Would a Principle along the lines set out above adequately accommodate the functioning of so-called transparent holding systems?

Q3: If not: can you explain which aspect is not correctly addressed and what could be improved? Which are, if applicable, the repercussions on your business model?

3.2.1.2 Statistical Response

Yes	6
Qualified yes	57
No	2
No answer	43

3.2.1.3 Synthesis

65 respondents answered this question. 6 contributors supported Principle 2 as it stands without any comments.

Meanwhile, 2 stakeholders opposed to the principle were some intermediaries acting functionally as account providers would be legally re-characterised as mere "account operators" because:

- *"sharing of function is a disturbing provision for investors, even in a transparent system"* (Af2i),
- *"in terms of civil law, it makes no difference if a CSD or a custodian performs its duties by either using its own means or by subscribing to services from third party providers (outsourcers)" and "outsourcing should rather be addressed in the context of supervisory law"* (DBB).

However, 57 stakeholders were generally in favour of providing for a distinction between the different holding systems. However, they also voiced a number of comments which revealed a diverse understanding of the "shared function" concept in terms of the holding systems covered. The Greek CSD stressed that Helex and the Dematerialized Securities System's (DSS's) participants were not sharing as common functions any account provision or account operation or custodianship towards the account holders, but were exercised by Helex and DSS participants respectively in an exclusive manner.

Some found the actual concept of a "transparent holding system" inappropriate because:

- in general the Nordic systems were not more transparent than other systems in terms of cross-border holding (EBF),

- it gives the impression that it creates a mandatory co-liability concept of the account provider and the "other person" towards the account holder (Helex),
- it was misleading because holdings on CSD accounts, in the Swedish context, were guarded by professional secrecy. Only the shareholder register was public or "transparent" (SE),
- a better description was to call the systems in the Nordic area "mixed systems" (NSA) because in those systems existed both direct holdings with the CSD as account provider as well as indirect holdings with banks or securities firms as account providers. As Sweden pointed out: "*Our legislation permits – rather than requires – direct holdings in the CSD*".

As regards the **scope of Principle 2**, 17 stakeholders proposed a restrictive approach and argued that the concept of "shared functions" should only be applied for the purpose of serving as a structure in countries where the CSDs follow the "**transparent systems**" approach.

This restriction should be specified in the envisaged legislation in order to prevent this concept from being misused for other cases, such as IT-outsourcing. A recital was suggested to elaborate on the distinction between permitted shared functions and excluded activities, including pure outsourcing or delegated arrangements.

Some stakeholders found that Principle 2 did not address the concerns of **direct-holding models, such as CREST**, where there was no account provider that performed any "securities holding" functions (i.e. no one interposed themselves in the proprietary chain between issuer and investor) and EUI as operator of CREST fulfilled only "account maintenance" functions (i.e. maintaining and updating the registers or records in response to instructions from the account holder).

This problem was not resolved by the "shared functions" concept precisely because there was no relevant function that such an account provider can "share" with the third party so as to transfer legal responsibility for them to the third party (CLLC-FLC, Euroclear, and CBI).

Principle 2 also did not address the problem of a **mixed holding model** such as the Swedish system. Euroclear explained that "*In the case of ES, the "person other than the account provider" who is responsible for certain of its functions is the licensed*

“account operator” which performs book-entry functions on behalf of ES participants or, in some cases, a nominee who holds securities on behalf of its clients in accounts which may include securities held with the CSD, with other intermediaries and in physical form. A proper definition of the “securities safekeeping” function would ensure that the SLD reflects the activities performed by these types of account provider more accurately”.

Moreover, the AGC argued for widening Principle 2 to also cover account operators that participated in indirect holding systems.

As regards the **division of responsibilities** vis-à-vis the account holder in a “shared function” situation the following remarks were made:

- Several respondents thought that any splitting up of responsibilities vis-à-vis the account holder should be avoided as it would add considerably to legal uncertainty (WKO, Pöch, and OeKB). Others stressed that it should be clear who was responsible for which services and performances (EACB). The DFSA argued that Member States should decide whether shared functions could be based on joint responsibilities.
- The Norwegian authorities reported that *“The Norwegian CSD Act states that a CSD shall establish rules related to the use of external account operators. As stated above, all functions related to the maintaining of securities accounts will be executed through the account operators. The CSD is responsible for financial loss due to negligence, whether performed by an account operator or the CSD itself. The account operators are responsible towards the CSD, but will not be responsible towards the customers/the account holders”.*
- BME suggested that the envisaged legislation should define the liability regime applicable to the different actors in a shared functions situation.
- NL noted that the envisaged legislation should contain a provision which dealt with the responsibility of “other persons” than the account provider. The account provider should ensure that that other party was able to meet the same standards as were applicable to the account provider itself, regarding legal protection to the account holders rights.
- Likewise, FR insisted that the recognition of the role of the “other person(s)” in the provision of services to the account holder must not impact the exercise of investors’ rights on the securities they own. The envisaged legislation should

clearly state that the use of “other persons” did not have any impact on the definition of who was the ultimate beneficiary of the rights attached to the securities and who was thus the only person who may take decisions in respect of those rights. The “other persons” should be considered in the same light as intermediaries who had both contractual obligations towards each other including the obligation to execute the decisions taken by the legal owner and beneficiary of the securities.

Two stakeholders highlighted the need for the envisaged legislation to ensure the compatibility of the “shared function” approach with other Principles, and specifically wondered how the relationship between account providers and account operators would work in relation to Principle 11 which imposes an obligation on intermediaries to take instructions exclusively from the account holder (EBF, AGC).

As regards **Principle 2.2**, two stakeholders believed that the accompanying notification measures seemed unnecessary (NO, Euroclear).

3.2.2.1 Question

Q4: Do you know any specific difficulties of connecting transparent holding systems to non-transparent holding systems?

3.2.2.2 Synthesis

34 respondents responded that they had not encountered any problems with connecting transparent holding systems to non-transparent systems.

A number of French intermediaries illustrated their experience using the following example: “A French investor purchasing Swedish Securities credits the securities to a securities account maintained by an intermediary in France. The French intermediary uses the services of a Swedish intermediary (a “person other than the account provider” in Principle 2.1 (1)), who operates the investor’s account in the books of the Swedish CSD. French law provides that the investor’s ownership rights appear in the investor’s account in the books of the French intermediary and Swedish law provides

that the investor's ownership rights appear in the securities account maintained by the Swedish CSD. However:

- This is not problematic, nor from the point of view of the treatment of rights flowing from securities; nor from the point of view of the investor protection in case of insolvency of the Swedish CSD, the Swedish account operator or the French intermediary and*
- The proposed Securities Law Directive's approach will not change this in the future".*

The Greek CSD highlighted the differences between the direct and indirect holding systems and provided for a long list of the benefits of transparent holdings systems for the investor and the issuer.

It called upon the Commission to support the competition between these two types of systems. Furthermore, Helex explained that an account operator (member, custodian or other CSD) of any EU Member State was able to access the Greek CSD and serve its client directly through the shared function with the CSD and therefore offer to its client competitive pricing by avoiding chains of intermediaries. However, if the intermediary serving the end client does not wish to do so for any reason and prefers to go through a chain of intermediaries in order to access the CSD, it can still do so and open the account in the end client's name.

Some stakeholders reported the following (potential) difficulties:

- Two stakeholders experienced difficulties due to different levels of transparency and disclosure requirements. The regulators of transparent jurisdictions tended to expect certain information on holders to be made available to them or to issuers. Such requests were difficult to accommodate when addressed to account providers in non-transparent jurisdictions. Even in the absence of banking secrecy legislation, the disclosure chains were burdensome due to the fact that there was neither a harmonised legal basis nor a cost assignment rule in cross-border holding scenarios (Clearstream, KDPW).
- Two stakeholders pointed out that from an operational and business perspective, transparent holding systems posed fundamental challenges because omnibus accounts could not be used (DACSI, AGC). *"If a transparent holding system*

requires that securities positions at the Central Securities Depository ("CSD") be segregated by ultimate account holder, then this requirement is passed down the custody chain to the ultimate account holder, so that all account providers are forced to use segregated accounts. This represents additional cost and complexity. In practice, only institutional investors can bear the cost and complexity, and retail investors are in effect barred from investing directly in securities deposited in that CSD' (AGC).

- CR, who operates depository interests in the UK for a Finnish company explained: *"There is a non-transparent holding system in Finland. In order to vote however the holding has to be transferred to the beneficiaries' names and the holding is removed from the market. This then has to be reversed after the meeting. For one or two holdings this is not a particularly large problem. However if significant numbers of holdings or shares are involved this creates additional work or potentially reduces liquidity in the market at certain times of the year. This can be interpreted as blocking and should have been removed. However this has not caused any problems to shareholders to date and has not been raised elsewhere"*⁶.

⁶ This response raised the following comments from the Finish authorities (sent by e-mail of 3.06.2011): 'This is very far from the truth. It is correct that while Finland generally has a transparent holding system, foreign investors are allowed to have their securities held by a nominee (custodian). In the case of shares, this means that while the "beneficiary" (the investor at the very end of the chain of intermediaries) is considered to be the legal shareholder (unlike, e.g., in the UK), a nominee (the "uppermost" intermediary, who holds a custodial nominee account with the Finnish CSD) may be entered into the shareholder register on behalf of the shareholder. Furthermore, to ensure a minimum level of transparency even for such foreign holdings, Finnish law (Limited Liability Companies Act) provides that a requirement for attending a general meeting with such shares is that the nominee must notify the company of the name of the actual shareholder, which is then temporarily (ie. for the purposes of the general meeting) entered into the shareholder register.

However, this is all that Finnish law requires. In order to vote, the holding does not need to be transferred from the custodial nominee account to an individual securities account held by the the actual shareholder, and it certainly does not need to be "removed from the market". The Limited Liability Companies Act provides for a record date system (cf. Article 7 of the Shareholder Rights Directive). In the context of nominee-registered foreign shareholders, this means that their right to attend the general meeting is determined by their holdings (at the end of the chain) on the record date, and any changes in the holdings after that date are irrelevant. The company is to be notified of the holdings as they are on the record date, regardless of later changes. Thus, Finnish law does not give rise to any need for share blocking.

We are aware that because of slow communication along the chain of intermediaries there have been market practices where some foreign intermediaries have actually blocked the holdings of their account holders in order to ensure that the holdings notified to the company correctly reflect the situation on the record date. In other words, since it has been necessary to pass on the information in question even before the record date, an intermediary may have blocked holdings until the record date. To abolish such market practices, the Limited Liability Companies Act was amended in 2009 so that while the holdings on the record date determine the right to attend the meeting, the notification of such holdings to the company can be made at a later date (but prior to the general meeting), as indicated in the convocation of the meeting. If any de facto share blocking by foreign intermediaries remain, it certainly does not result from Finnish legislation but possibly from inefficient communication and outdated market practises.'

- Clearstream expected difficulties in non-EU transparent systems with respect to:
 - (i) *“what is the exact legal qualification of the entities between the local CSD and the ultimate account holder (in part. where the local CSD does not identify directly the UAH in its book entries but has to reconcile with its direct intermediary);*
 - (ii) *liabilities of the direct intermediary of the UAH toward the CSD or such CSD’s direct intermediary;*
 - (iii) *change from custody to agency services for intermediary AP. Furthermore, we are aware of cases where transparent systems asked issuers holding their issue with a non-transparent systems as “home CSD” and intending to list their products in a regulated market serviced by a transparent system to explicitly state that the issuer accepts any booking of the transparent system as “investor CSD” irrespective of corresponding positions of the transparent system with the non-transparent system as “home CSD”.*

- Euroclear found that difficulties could arise in both directions: *“By way of example, when a non-transparent system (as investor CSD) connects to a transparent system, there is a risk that the rules of the transparent system consider the intermediary from the non-transparent system as the ultimate holder of securities. The other way around, when a transparent system (e.g. as investor CSD) connections to a non-transparent system (as issuer CSD), the investor CSD is by definition an intermediary. Transparent systems often operate in a domestic legal framework which focuses on domestic securities (e.g. in a dematerialisation context) and which does not cater expressly or in great detail for the holding of foreign securities by the CSD.*

(...) Difficulties can arise for transparent systems (such as ES) where the provisions of national laws governing the non-transparent system mean that the issuer of securities cannot recognise the account holders in the CSD as the holders of the security, for example because those laws only recognise the rights of the person who presents a bearer security, or because they do not recognise omnibus or nominee holdings”.

3.3 Principle 3

3 - Account-held securities

- 1) *The national law should clarify that securities standing to the credit of a securities account confer upon the account holder at least the following rights:
 - (a) *the right to exercise and receive the rights attached to the securities if the account holder is the ultimate account holder or if, in any other case, the applicable law confers the right to that account holder;*
 - (b) *the right to effect a disposition under one of the harmonised methods (cf. below);*
 - (c) *the right to instruct the account provider to arrange for holding the securities with another account provider or otherwise than with an account provider, as far as permitted under the applicable law, the terms of the securities and, to the extent permitted by the national law, the account agreement and the rules of a securities settlement system.**
- 2) *The national law should make sure that account holders which act in the capacity of account provider for a third person exercise the rights (b) and (c), above, in accordance with the instructions of that person (see below).*
- 3) *In case of acquisition of a security interest or other limited interest in account-held securities the national law of should be able to restrict the rights (a)-(c), above.*
- 4) *The national law should be allowed to characterise the legal nature of account-held securities as any form of property, equitable interest or other right as far as the characteristics flowing from the legal nature is in accordance with the rights (a)-(c), above, and the remainder of any legislation.*

3.3.1.1 Questions

Q5: Would a Principle along the lines described above provide Member States with a framework allowing them to adequately define the legal position of account holders?

Q6: If not, which legal aspects that belong, in your opinion, to an adequate legal position of each account holder could not be realised by the national law under an EU framework as described above? What are the practical problems that might occur in your opinion, if Member States were bound by a framework

as described above? Which are, if applicable, the repercussions on your business model?

3.3.1.2 Statistical Response

Yes	12
Qualified yes	43
No	28
No answer	25

3.3.1.3 Synthesis

83 stakeholders responded to this question. 12 respondents supported Principle 3 without comments.

43 contributors provided either an affirmative answer with some remarks or provided only remarks without taking a clear stand:

- There should be a clear distinction between “account holder” and “ultimate account holder” because they obviously did not enjoy the same rights. Intermediaries should not be granted ownership but only possession rights (VAB).
- There is a lack of certainty as to whom an account provider is accountable.
- The acquired legal position of each account holder can be only a very general description because the rights allocated to securities are laid down in national company laws that may vary in different Member States. Such characterisation might be too strong a simplification.
- The envisaged legislation should allow account providers to distinguish between securities accounts (which would have the legal effects specified in the principles) and other records relating to securities (which do not). For example, a custodian acting prudently will keep a record of all securities formerly held in custody but lent out by its clients; such records would not constitute "securities accounts" as they merely represent contractual, rather than proprietary, entitlements of clients, to have such securities returned at the end of the loan (AGC, ISLA).
- The conflict of law rules should be improved in order to solve all the conflict cases between the applicable law of the account provider and the lex societatis (Af2i). It

needs to be decided by conflict of law rules what the "national law" in Principle 3 and 4 are (EACB).

- The Principle will be difficult to apply outside the EU (ABBL). The scope of the envisaged legislation should be limited to EU securities (AGC) held in a European CSD (DACSI). The envisaged legislation should at least allow for EU account providers to contractually restrict the rights of their account holders where assets are ultimately deposited in an account provider outside the EU (Clearstream).
- The envisaged legislation should permit the parties to amend the rights of the account holder by contract to exercise account-held securities, e.g. an agent lender may seek to place contractual restriction on a client's ability to deal with collateral received under a stock loan in order to ensure that it is available to be returned to a borrower or sold by the agent on behalf of the account holder in the event of a borrower default (ISLA).
- Legal aspects associated with account holders which utilise nominees to hold the bare legal interest on behalf of the holders of the beneficial interests in securities (who themselves can be holding such beneficial interests on behalf of other account holders) may not be realised by the national law under the proposed EU framework. It will be difficult to define the legal position of account holders without importing specific concepts akin to such trust arrangements into the relevant national law (Pinsent).
- Principle 3 should be subject to national law regulating issuer obligations and contractual provisions limiting participation rights (SE).
- As regards **Principle 3(1)(a)** the envisaged legislation should recognise that the security holder can assert these rights against the issuer, without having to rely on the account provider or any other intermediary (ZKA, ESBG, EAPB).
- Some elements of Principle 3(1)(a) do not sit well with existing differences in Member State rules on investor rights. Specific rights given to ultimate account holders appear to allow them to "leapfrog" over the proximate account-provider, as they appear to be exercisable against other persons in the holding chain with whom the ultimate account holder has no contractual, property or regulatory relationship. While such "leapfrog rights" are prohibited in some Member States (where the ultimate account holder is entitled to exercise the rights of an owner solely as against its account provider), they are mandatory in other regimes

where intermediation is treated as a matter of property law and the position of an "ultimate account holder" is that of the owner of a security (AGC, CLLS-FLC).

- Principle 3(1)(a) should be clarified by the inclusion of a provision to the same effect as Article 9(2)(b) of the Geneva Securities Convention (and Article 10 of Recommendations of Legal Certainty Group) to ensure that English company law can continue to give the "ultimate account holder" no direct rights as against the issuer to exercise rights attached to the securities held in an account in its name so that the "ultimate account holder" must give instructions which are passed on up the chain to have any effect on the conduct of the issuer or any intermediate account provider. If the envisaged legislation were to require such a change this would contradict Article 345 TFEU (CLLS-FLC).
- The envisaged legislation should provide that rights flowing from securities can and must be exercised directly only by the ultimate account holder. Another account holder may exercise these rights only upon instruction of the ultimate account holder but must not be regarded by national legislation as the "shareholder" or in any other way as holder of these rights (EACB, FR).
- It is not practicable (in the absence of a transparent and auditable system for recording securities holdings across Europe ensuring end-to-end integrity of securities accounts) to give ultimate account holder rights against anyone other than his immediate account provider as Article 9(2)(b) Geneva Securities Convention does (Computershare).
- The envisaged legislation should clarify that the ultimate account holder which is not the legal holder can only exercise and receive the rights towards its own account provider while the legal holder can exercise them directly against the issuer (BE).
- Preferred shares that do not entail voting rights would not fit into the purported list characterising securities (WKO).
- The envisaged legislation should provide that the law governing the securities creates the rights flowing from securities (EACB).
- It should be clarified that **Principle 3(1)(c)** reflects only the possibility for the account holder to move his securities to another account provider. This should not impose an obligation on the account provider to enter into business relationships with depositaries according to the choice of the ultimate account holder and to

move the holding of securities to the account held by the account provider in the upper level of the holding chain or between two members of an existing international link (KDPW). The ultimate account holder should have the right to instruct only *his* account provider and may not instruct at any level of account providers in a chain (DACSI, EBF).

- The limitation of **Principle 3.4**, which provides that national law may freely characterise securities as ownership only as long as rights of account holders are preserved, should be reconsidered (DE, DBB).

28 stakeholders (French intermediaries and academics, German issuers and investors) were of the opinion that Principle 3 would not adequately define the legal position of account holders because:

- The introduction of the term “account-held securities” creates legal uncertainty as it adds an additional concept to the already existing notions under MiFID (“financial instruments”, including “transferable securities” and “units in collective investment undertakings”), UCITS IV Directive (“transferable securities” and “transferable instruments”) and Geneva Securities Convention (“securities” and “intermediated securities” which may be a new category of securities). The term “account-held securities” needs to be replaced with the term “securities” because it is clear that in Principle 4.2 “securities” mean “certified securities” in subparagraph d and “account-held securities” mean “dematerialised securities” in subparagraph a.
- Principle 3(4) providing that national law should be allowed to “characterise the legal nature of account-held securities as any form of property” would amount to giving ownership rights to each member of the chain, even to account holders who are mere intermediaries. This would necessarily create to the benefit of each intermediary a specific asset which they could dispose of freely. At each level of the chain a “securities settlement” = “account-held security” distinct from the underlying asset would be created. As a result, the creation of “account-held securities” distinct from “securities” would lead to a situation where the same securities could be disposed several times. This would lead to lack of securities in case of a liquidity crisis (Lehman case with the mechanism of re-use which allows the same multi-dispositions of the same securities).

- The assertion that disposition of securities is available to any account holder in a chain of players is unacceptable for the clear reason that the securities are not held by that account holder but only the owner's account holder. All the other accounts are simply shadow accounts and in no circumstances might be considered as legally evidencing the securities concerned.
- There should be a clear distinction between the account holder, who is an intermediary and the account holder, who is the final investor, for the purpose of the application of the Market Standards on General Meetings and on Corporate Actions.
- There is no need to refine the understanding of who is the person entitled to exercise the rights attached to securities which is a matter of the applicable corporate law and a list of minimum attributes has already been harmonised by the Shareholders Rights Directive. Establishing a list of minimum rights will not create certainty, quite the contrary as the description of the proposed list can not necessarily be tied up with the SRD corresponding definitions. Therefore the core-rights conferred upon the account holders should be replaced by equivalent core-duties on account providers.
- The exercise of rights listed in Principle 3(1) can only be possible in line with and according to applicable corporate law/bond law. Thus, the principle is only applicable to the relationship between the account holder and the account provider and within the safekeeping chain (DAI-GDV-BDI).
- Of importance to German issuers and investors is that the envisaged legislation makes clear that title is evidenced (but not created) by book-entry on the securities account maintained by the relevant intermediary in the name of the investor.
- The Principle would not help identifying the person entitled to vote without the introduction of a **shareholder identification principle** (German issuers and investors). Obstacles to shareholders identification provided for under some applicable corporate laws stem from the fact that intermediaries down the holding chain often oppose identification requests lodged by issuers seated in another Member State on the ground that the law applicable to the account agreement signed between the intermediary and the end investor is based on a different applicable law.

- In order to ensure that rights to securities are allocated to the appropriate party and that the exercise of such rights is given effect to, integrity of the entire chain of securities must be ensured (Computershare). This is only ultimately feasible under a transparent and fully auditable holding system, where the issuer is able to directly identify the party that is entitled to exercise rights against them in respect of securities holdings (the issue of shareholder transparency is being discussed in relation to the work of the Taskforce on Shareholder Transparency as part of the Target-2 Securities (T2S) project and also the review of the Transparency Directive).

The following potential impacts on business models were expected:

- In terms of risk appreciation, French intermediaries did not expect that there would be increased certainty in the holding and transfer of securities in the EU after the transposition of the envisaged legislation as it stands. As a result no positive re-calculation of the equivalent risk model was expected (in contradiction to the transposition of the Financial Collateral Directive which resulted in increased certainty as to enforcement of collateral, which lowered the equivalent risk, allowing account holders to immobilise less collateral).
- As it is unclear who will ultimately bear responsibility for ensuring that the end investor is able to enjoy all rights attaching to its securities, it is expected that the duty on account providers to facilitate the exercise of those rights will lead to a number of practical and operational difficulties which will result in increased costs in order to ensure compliance with the proposed obligation.
- The lack of certainty as to whom an account provider (including CSDs) is accountable could create increased systemic risk, particularly in times of market stress.
- The business model of all intermediaries would be severely affected if they were obliged to make inquiries in relation to account holders further down the intermediated chain. Costs would be significant if they were required to insure against liability to an unknown person or persons, when in practice they have to deal with their immediate client (account holder) in accordance with its instructions. The proposed model would substantially increase the risk of multiple claims, whereas when an account provider only has a legal responsibility to act in

accordance with the instructions of its immediate account holder this risk does not arise.

3.3.2.1 Question

Q7: The Geneva Securities Convention

(www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm)

provides for a global harmonised instrument regarding the substantive law (= content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing this subject. Most EU Member States and the EU itself have participated in the negotiations of this Convention. Both the present approach and the Convention are compatible with each other.

- If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?
- Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?

3.3.2.2 Statistical Responses

Does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?

Yes	17
No	2
No answer	75

Is it important to achieve global compatibility with Geneva Securities Convention?

Yes, pure compatibility	20
Yes, but minor derogations should be allowed	11
No, specific adaptation to EU context	20

Against global compatibility	10
No answer	47

3.3.2.3 Synthesis

61 stakeholders answered this question. Although it is difficult to establish clear cut distinctions, 20 asked for a pure compatibility (AT, UK, Nordics and third countries), 11 for minor derogations (German intermediaries and CSD, BE stakeholders), 20 for a specific adaptation to the EU context (French intermediaries, some UK issuers or investors) ,while 10 stakeholders were opposed to a transposition of the Geneva Securities Convention.

The ECB stressed that CSDs located outside the EEA may participate in T2S, which would therefore help the settlement of transactions involving non-EU account providers and holders.

Using data from the International Monetary Fund, the UK underlined the need for global compatibility because:

- EU investors directed 32% of their capital into cross-border securities outside the EU (they invested US\$ 6.6 trillion in securities outside the EU) and cross-border investment by EU investors in non-EU securities increased in value terms between 2008-9 and 2009-10 by 25%, so that it was becoming more and more important to protect the rights of these EU investors,
- Non-EU investors provided 27% of the total investment in EU cross-border securities (this meant that US\$ 5.2 trillion of cross-border investment in EU businesses came from outside the EU) and cross-border investment in EU securities by non-EU investors increased in value terms between 2008-9 and 2009-10 by 26% - this should be seen as a key enabler for the EU's 2020 strategy for smart, sustainable and inclusive growth.

3.4 Principle 4

4 – Methods for acquisition and disposition

1. *The national law should provide for acquisitions and dispositions of account-held securities and limited interests therein to be effected by crediting an account and*

debiting an account respectively.

2. The national law should provide that an account provider may credit the accounts of its account holders, for each description of securities, only if it holds a corresponding number of securities of the same description by

(a) having available account-held securities in a securities account maintained for the account provider by another account provider;

(b) arranging for securities to be held on the register of the issuer in the name, or for the account, of its account holders;

(c) holding securities as the registered holder on the register of the issuer;

(d) possessing relevant securities certificates or other documents of title; or

(e) creating the initial electronic record of securities for the issuer in accordance with the applicable law

and that an account provider continuously holds that corresponding number.

3. If the applicable law allows crediting and debiting to be made conditional it should also define the extent to which such conditional crediting or debiting is taken into account in determining the number of securities referred to in the preceding paragraphs. Credits to a securities account the effectiveness of which is subject to a condition must be identifiable as such in the account.

4. If a corresponding number (paragraph 2) is not held, the account provider should promptly apply either or both of the following mechanisms in order to re-establish compliance:

(a) reverse erroneous credits;

(b) provide additional securities of the relevant description, to be held by one of the methods provided for in paragraph 2.

The sharing of any cost entailed by the provision of additional securities pursuant to subparagraph (b) can be subject to a contractual agreement between the account provider and those account holders holding securities of the relevant description at the time of the occurrence of the loss in non-segregated accounts only in cases where the account provider held securities of the relevant description with another account provider pursuant to Article 17(3) subparagraphs (a) and (b) of the MiFID.

5. The applicable national law may in addition allow for acquisitions and

dispositions being effected under one or more of the following methods:

(a) earmarking account-held securities in an account, or earmarking a securities account, and the removing of such earmarking;

(b) concluding a control agreement; or

(c) concluding an agreement with and in favour of an account provider.

3.4.1.1 Questions

Q8: Would a Principle along the lines described above allow for a framework which effectively avoids that more securities are credited to account holders than had been originally issued by the issuer?

Q9: If not, how could a harmonised EU-framework better guarantee that account providers do not create excess securities by over-crediting client accounts (keeping in mind that all account providers are either banks or MiFID regulated entities)? Please distinguish between regulating the account providers' behaviour and issues relating to the effectiveness of excess credits made.

3.4.1.2 Statistical Response

Yes	11
Qualified yes	38
No	30
No answer	29

3.4.1.3 Synthesis

79 stakeholders responded to questions 8 and 9. 11 contributors confirmed that Principle 4 would allow for a framework that effectively avoids that more securities are credited to account holders than had been originally issued by the issuer.

38 stakeholders could support Principle 4 if the following suggestions were implemented in order to better guarantee that account providers do not create excess securities by over-crediting client accounts:

- To introduce a "pro-rata sharing" mechanism in Principle 4.4, which orders the account provider to promptly reduce the credits in the respective security proportionally on the accounts of all account holders. This mechanism may only be used in cases where the other two mechanisms (reversal, "buy-in") are not promptly available. This mechanism is especially important in order to prevent further fictitious "acquisitions in good faith" (BE, WKO, Pöch, OeKB, ZKA, UniCredit-Group, EACB, and EAPB). Providing for other corrective measures in case of shortfalls was also advocated by the SSDA.
- To establish different mechanisms of supervision by determining a competent, national or European, supervisory authority, entitled to monitor and ask the intermediaries, auditors and CSD to issue on a timely basis certificates in order to assure that the right numbers of securities are, from time to time, recorded in each account provider's records (French intermediaries). Also proposed by DAI-GDV-BDI and DACSI.
- To incorporate a positive obligation on account providers to periodically reconcile their positions (Computershare, ICSA, EuropeanIssuers, CBI).
- To use the formulation from Article 24(1) of the Geneva Securities Convention (CLLS-FLC).
- To include other circumstances in the list in order to cover Euroclear France (which credits securities accounts of its participants on the basis of holdings in its own so-called issuance accounts, which represent the entirety of the securities in each issue) and EUI (which does not hold securities although it makes credits to the relevant CREST accounts).
- To replace "having available" in Principle 4.2 lit. a with "having securities credited to its securities accounts, maintained by another account provider".
- To delete Principle 4.2 lit. b and c because they are already catered for in lit. a or lit. d and to replace the word "credit" with "creditings" (IT).
- To remove Principle 4.2 lit. e (UK and ICSA which were concerned about its purpose and impact on CREST) or to restrict it only to CSDs (French intermediaries, VAB).
- To supplement legal duties with appropriate and harmonised regulatory and accounting standards (ECB).

However, 30 stakeholders asserted that the integrity of the issue could only be protected by the "no credit without debit" rule:

- The envisaged legislation should be based on the so-called "holistic approach" to debiting and crediting as this is the best method to ensure the integrity of the issue (FR, DE).
- There should be a legal obligation for account providers to:
 1. only credit accounts when there is a corresponding debit ("no credit without debit") and;
 2. always maintain a number of securities that correspond to the number credited to the accounts of the investors and that this should translate into adequate accounting principles (German issuers and investors, EuropeanIssuers).
- Two different rules should be introduced:
 1. The number of securities in circulation must not exceed the number of securities issued (the number of securities in circulation must be measured at the level of the owners' securities account holders) and;
 2. There must be one credit entry and one debit entry for every transfer of ownership of securities (French academics).
- According to DBB, under Principle 4 an overlap could regularly occur between securities credits standing to the account of both the old and the new investor. This would entail a duplication or creation of "securities ". Therefore DBB suggested the following wording of Principle 4.1: "... by *both* crediting and debiting of accounts [*upon instruction of the owners/ultimate account holders*]." If the Commission wished to keep the current principle, a rule applicable to *non-ownership systems only* could be a solution: "*Where national law does not follow the ownership concept, at least the crediting an account and debiting an account respectively shall lead to the acquisition and disposition of account held securities....*".
- DAI-GDV-BDI proposed to introduce a clause that makes clear that any crediting can only be effective if there is a corresponding debit entry.
- However, DACSI remarked that the introduction of a "no credit without debit" rule in the sense of a legal conditioning would hardly be compatible with the

characterisations of account-held securities in the legal systems of all Member States and therefore wouldn't stay within the limits of a functional approach. The CLLC-FLC also stressed that any measures adopted to protect investors' holdings of securities should "*at all costs avoid imposing doctrinaire requirements which fail to accommodate the practicalities of swift and efficient settlement*".

The following general comments in terms of Principle 4 were made

Many stakeholders requested that Principle 4 be broken down and a specific section introduced on the integrity of the issue in order to adequately address the threat of securities inflation, (FR, IT, French intermediaries, German issuers and investors, and European Issuers).

However, other stakeholders asserted that the danger of "securities creation" by account providers was unwarranted (AGC) and that "*this question has got too much attention*" (SSDA). It was contested that any credit which exceeds the number of securities in existence would result in the creation of additional securities because "*a securities account is not a copy of the issuer's register of shareholders (which is the final determination of a shareholder's entitlement), or of the issuance account at the issuer CSD*" (AGC). Instead, a securities account only "*creates a liability of the account provider to its client, and no more*".

Diverging views were also expressed as to whether any temporary inflation of securities should be permitted:

- French intermediaries pointed out that inter-day or less than 24 hours inflation exists in some jurisdictions - allowing for significant cost reduction and flexibility in the settlement process. Against this background they advocated considering integrity only statically, (i.e. securities credited to securities accounts), and not dynamically, (i.e. the settlement process).

Af2i pointed out that the envisaged system might not always work because settlement cycles may last several days after the transaction is concluded and series of transactions in a short time may put the account holder in a position of not having the securities at hand in absolutely all cases, even if they are in the process of being delivered, as a result of another transaction.

CR felt that Principle 4 should be redrafted so that full reconciliation rather than matching should be the accepted position.

- However, ZKA and EAPB asserted that even the mere temporary existence of an excess holding cannot be accepted.

BE highlighted the relationship between Principle 4 and Article 19 of the MIFID Implementing Directive (2006/73/EC) on "rehypothecation" of securities at the upper tier level. In the case of a "re-use" in the books of the account provider of the client, there should be a debit of the account of the client having authorised the re-use and a corresponding credit. Principle 4.1 would be respected.

However, **where the re-use takes place at the upper tier level** or, in the words of Article 19 of the MIFID Implementing Directive, where the investment firm uses financial instruments held on behalf of a client in an omnibus account maintained by a third party (through a debit of that account), according to BE **it is neither market practice nor indisputably required by the MIFID to effect a corresponding debit of the account of the client in the books of the investment firm.**

Per definition, it seems that such re-use implies an imbalance which would be in violation with the principles set out in Principle 4.1 ("*(...) that an account provider continuously holds that corresponding number*"). BE proposed two possible interpretations to resolve this situation:

1. The account provider must debit the account of the client in its books where it uses the instruments held on behalf of this client with an upper tier account provider; or;
2. The imbalance is tolerated, under the condition that the account provider "promptly" resituates the re-used financial instruments. The interpretation of the term "promptly" would take into account the arrangements regarding restitution agreed upon between the account provider and the client.

In terms of "re-use", French intermediaries, EACB and VAB stressed that where a security was transferred, only the transferee should have the power to re-use that security (and not the transferor).

Some stakeholders felt that the principles did not reflect the reality of securities lending, (CR, AGC, and CONF.1). These transactions typically involved debiting the securities from the client's securities account as part of the process of transfer to the borrower. Whilst the lender's custodian kept a record of the securities lent, this record did not constitute a "securities account." They were unclear as to how the envisaged legislation would apply in such cases.

ICMA observed that the use of separate depot accounts for the repo settlements as distinct from cash security transactions had the potential to complicate the single view of unfunded positions.

Finally, the consultation revealed a misunderstanding that it is not the Commission's intention for Principle 4.2 to oblige Member States to introduce all five methods of holding into their law (this was apparently assumed by French intermediaries, EACB, and the UK).

There was also discussion about the methods for acquisition and disposition (Principle 4.1 and Principle 4.5).

In reference to the Financial Collateral Directive, (which distinguishes between "title transfer financial collateral arrangement" under which full ownership of collateral is transferred and "security financial collateral arrangement" under which collateral by way of security is provided), and to the Geneva Securities Convention, (distinguishing between "the right to effect a disposition" and "the right to grant an interest"), many stakeholders (FR, French intermediaries, German issuers and investors, DAI-GDV-BDI, VAB, DACSI) advocated that a distinction should be introduced between:

- methods which lead to a transfer of ownership, and;
- methods which are used only for taking security collateral. Earmarking of securities should not be considered as evidence of transfer of title but only as the creation of limited rights.

The following drafting suggestions were made:

- Principle 4.1 should be restricted to "acquisition and disposition with title transfer" and Principle 4.5 to "acquisition and disposition without title transfer". (FR)

- *“Article N - Methods for acquisitions and dispositions. Member States shall ensure that securities are acquired by the credit of securities to the acquirer’s securities account. The owner of securities disposes of securities by the debit of securities to his securities account. A Title Transfer Financial Collateral Arrangement, as defined in Directive 2004/47/EC, may be effected by debit and credit of securities to securities accounts under this article.*

[To be completed with the necessary caveats on “no impediment on company law” and “reversals”].”

“Article N+1 - Methods for Security Financial Collateral Arrangements

Member States shall ensure that collateral givers give effect to Security Financial Collateral Arrangements, as defined in Directive 2004/47/EC, or grants a limited interest other than Security Financial Collateral to an Collateral Taker, if:

The Collateral Giver enters into an agreement with or in favour of that person; and

One of the following conditions applies:

- *The collateral taker is the relevant intermediary;*
- *An earmarking in favour of the collateral taker has been made;*
- *A control agreement in favour of the collateral taker applies.” (French intermediaries)*

- DBB: Principle 4.5 should read: *“the applicable national law shall foresee for dispositions/acquisitions of limited security rights to be effected upon [instruction of the parties and] dispossession/acquisition of physical control, including without limitation: [follows enumeration]...” (DBB)*

However, Euroclear opposed the creation of closed list of circumstances in which Member States may permit acquisitions and dispositions, since this would not only limit their ability to respond to future technical developments, but it would mean that some methods by which acquisitions and dispositions were currently permitted to take place would not be recognised (examples of Finnish and Dutch law).

Similarly, CLLC-FLC suggested in reference to Article 13 of the Unidroit Convention that the envisaged legislation should make it clear that the methods for acquisition and disposition provided for in Principle 4 do not preclude additional methods under

national law (e.g. a trust or equitable assignment may additionally be used to effect a disposition of an interest in account-held securities under English law).

The following comments were made on Principle 4.3 (conditional credit):

- DBB perceived Principle 4.3 as intending to “allow” ownership systems to link the crediting to the required debiting and saw no merit in foreseeing such a “backdoor entrance” for the ownership system.
- According to some stakeholders the requirement that any "conditional credit" must be identifiable as such in the account would result in:
 - very substantial additional costs which would inevitably fall on investors in the form of higher transaction costs without any material gain in the protection of their holdings (CLLC-FLC),
 - heavy administrative burdens and even if it was technically feasible, identification for internal purposes should suffice (ESBG, DAI-GDV-BDI). In order to prevent banks from considerable adaptations to their IT landscape EACB suggested re-phrasing Principle 4.3 in the following way:
“Credits to a securities account the effectiveness of which is subject to a condition must be identifiable as such for the account provider and information must be given by the account provider to the account holder upon request.”
- Some stakeholders welcomed that Principle 4.3 allows for conditional credits as this would adequately cater for contractual settlement (AGC).

3.4.2.1 Question

Q10: Is the Principle relating to the passing on of costs of a buy-in appropriate? If not, in which way should it be changed and why? What would be the repercussions on your business model?

3.4.2.2 Statistical Response

Yes	1
No or qualified no	35
No answer	72

3.4.2.3 Synthesis

36 contributors provided answers.

Only one stakeholder responded that the principle relating to the passing on of costs of a buy-in was appropriate (ICSA).

35 contributors believed that the principle was inappropriate and/or voiced the following concerns:

- Some respondents disagreed with the "buy-in" principle because it appears to run counter to the "no credit without debit" rule (10 German issuers and investors, DAI-GDV-BDI).
- The ECB observed that on one hand, the principle was in line with the objective for the protection of investors and should be supported. On the other hand, the proposed principle was not the market standard in a number of jurisdictions. Principle 4(4)(b) might increase the costs of account provider, who would need to set aside more capital to guarantee the return of securities with limited possibility to disclaim their liability. If more securities holders are affected, pro rata sharing of costs should be introduced, unless there is full segregation of customer assets.
- Although this principle does not establish a new civil liability regime as such, a number of stakeholders claimed that it would effectively impose strict liability for loss on the account provider as it would oblige each account provider to buy-in regardless of fault on the part of the account provider (UK, SE, CLLS-FLC, FMLC, AGC, IMA, and Citi).

- Views differed over whether **over-crediting was in most cases "the fault of the account provider, either directly or through the fault of his custodian"** (WKO, PÖCH, OEKB, EACB) or **whether it was due to circumstances where the account provider was wholly without fault** (AGC: "*Where the CSD or other upper tier account provider erroneously credits the account of a custodian, the custodian has no means of knowing that the credit is in error until a query arises. In this situation, the custodian in good faith believes the credit to be genuine and its client to own the credited securities. When the error comes to light the credit will be reversed*").
- Some believed that **where the circumstances giving rise to the need for additional securities were not within the control of the account provider** (e.g. where there was **fraud or technical malfunction higher in the intermediary chain**), both the account provider and the account holder were innocent parties, and it was not appropriate for the loss to be imposed solely on the account provider (UK).
- While it was appropriate to require account providers to use reasonable care and skill in the selection of custodians and others who hold securities on behalf of their account holders and to have appropriate procedures in this area, it was inappropriate to make account providers strictly liable for the default of other account providers in the holding chain. Account providers should be able to pass on the costs of any measures to rectify imbalances onto their account holders, except insofar as they are necessary as a result of the account provider's negligence or wilful default (Euroclear).
- There were no reasons for letting account providers bear the cost of buy-in in all cases. In particular, the **account holders should be responsible for the costs if the account holders have caused or contributed to the shortfall** (EBF, SSDA).
- Others observed that it was not the practice for intermediaries to seek a blanket disclaimer of liability for other account providers, but it was common for them to disclaim or **limit liability for losses which were not attributable to some failure on their part to take reasonable care** (CLLS-FLC).

The following potential impacts on business models were expected:

- The imposition of a strict duty on account providers to immediately make up shortfalls of securities that occur in their accounts, but without enabling them to pass the costs on to their account holders, would have broad unintended consequences for the EU's markets. The effect of Principle 4(4)(b) was to make lower tier intermediaries insurers of the solvency, integrity and operational efficiency of higher tier intermediaries, including CSDs, both within and without the EEA. Alternatively, it would require CSDs to assume a standard of liability which may exceed their financial and business capabilities. **The above risks and subsequent cost burdens may compel some custodians to withdraw from the market, which would reduce effective market competition and investor choice (AGC).**
- The "buy-in" principle set out in Principle 4(4)(b) would have repercussions on regulatory capital requirements of account providers (at present custodial services are regularly priced on the basis that they trigger very low capital) and is likely to result in some players exiting the market (IMA, AGC, Citi, CLLS-FLC). It has been estimated that **the increased capital requirements needed to insure for strict liability would be up to an additional \$1 of capital for each \$1 of custody asset, in the context of an industry where the top four custodians collectively hold in excess of \$70 trillion in assets under custody (UK).**
- Enforcing a no-fault liability on account providers would undermine the risk management and hence business models of most custodians. EBF reported that most CSDs apply a strict "pro-rata" loss sharing to all their participants according to their General Terms and Conditions. Either financial intermediaries *"would have to write de facto "insurances" on such infrastructures without being compensated for them or CSDs would be required to assume financial liability which could far exceed their financial and business capabilities. Either way, such a rule would be detrimental to investors and amount to a substantial change of the commercial nature of this business."*
- From Euroclear's perspective, Principle 4(4)(b) increases the risks and costs inherent in the provision of international services to an unviable level. The value of international securities held via CSD links is in some cases extremely large and a risk of this magnitude would not be tolerable to the CSD from a business perspective. CSDs might have no alternative but to cease provision of their cross-

border service as they do not have the risk profile to absorb the liability that could result from this principle. If this pattern is repeated elsewhere, the SLD may have the effect opposite of that which it intends, i.e. it may actually limit cross-border holdings and dispositions of securities.

- Where a sub-custodian is located in a non-EU country, where equivalent duties and liabilities do not apply, there is also the additional issue of importing systemic risk into the EU (UK).
- Principle 4(4)(b) would lead to unjustified differences in the risks incurred by some account providers and it would privilege the position of an EU account provider which is linked directly to an account provider in a third country (KDPW).
- Such a measure would give third country account providers a competitive advantage (UK).
- Settlement would take longer and new systems would be very expensive (EAPB, ESBG).
- Any restrictions on the ability to share costs in relation to segregated accounts may reduce investor protection, given that such accounts are often provided at the request of the client (Citi).

The following solutions were proposed:

- Several stakeholders suggested aligning Principle 4(4)(b) with Article 21(11) of the AIFMD, allowing for "force majeure". The UK suggested the following drafting amendment:

"The sharing of any cost entailed by the provision of additional securities pursuant subparagraph (b) can be subject to a contractual agreement between the account provider and those account holders holding securities of the relevant description at the time of the occurrence of the loss in non-segregated accounts only:

(a) in cases where the account provider held securities of the relevant description with another account provider pursuant to Article 17(3) subparagraphs (a) and (b) of Directive 2006/73/EC; or

(b) in cases where the need to provide additional securities arose as a result of an external event beyond the reasonable control of the account provider, the

consequences of which would have been unavoidable despite all reasonable efforts to the contrary”.

- Some respondents proposed that a passing-on of costs of a buy-in should only be admissible if the account provider is able to demonstrate that he is not responsible for the shortfall (AT, KO, PÖCH, OEKB, and EACB).
- This rule should by analogy also apply to the compensation for damages in cases where the account provider has to apply the third mechanism (proportionate reduction) when he can prove that the situation was not caused by faulty behaviour on his part (WKO, PÖCH, OEKB).
- Clearstream argued that buy-in should only be imposed on an account provider where:
 1. a discrepancy is established and cannot be addressed, otherwise;
 2. a discrepancy results from the negligence of the account provider and;
 3. it is possible (there are securities in the market).

It highlighted that making account providers responsible to buy-in in case of insufficient aggregated positions would not be effective when a position was not liquid (which was probably the sort of security for which over-crediting was most problematic).

- Euroclear favoured a simple requirement that account providers, when performing securities safekeeping functions, should have appropriate procedures to deal with discrepancies. Any mandatory reversal/“buy-in” solution would not be sufficiently flexible to take account of the range of circumstances which might lead to discrepancies between securities held and securities credited because, *“cross-border transactions often involve re-alignment issues. If such an issue causes a discrepancy, the Principle suggests that the account provider should rectify it “promptly” by either reversal or buy-in. What then happens if the re-alignment issue is resolved? Should the account provider absorb any excess bought-in securities?”*

3.5 Principle 5

5 – Legal effectiveness of acquisitions and dispositions

- 1) *The legal nature of dispositions over account-held securities effected under one of the methods listed in Principle 4 would be determined by the national law, as far as the legal nature does not contravene the Principles.*
- 2) *No further steps than those set out in Principle 4 paragraphs 1 and 5 should be required to render an acquisition or disposition effective between the account holder and the account provider and against third parties.*
- 3) *To the extent that the requirements of Principle 4 paragraph 2 are not met, and until measures under Principle 4 paragraph 4 are successfully applied, the national law, or the rules of a settlement system in accordance with the applicable law, should determine, subject to Principle 8 below, whether and in what circumstances a credit is legally ineffective, liable to be reversed or subject to a condition, and the consequences thereof.*
- 4) *Acquisitions and dispositions arising by mandatory operation of the national law are effective and have the legal attributes, in particular rank, attributed by that law.*
- 5) *Effectiveness in the above sense does not determine whom an issuer has to recognise as legal holder of its securities.*
- 6) *The effectiveness can be made subject to a condition in accordance with national law.*
- 7) *The national law prescribes whether the credit is legally ineffective, liable to be reversed or subject to a condition, and the consequences thereof if the terms of issue of the relevant securities, in accordance with the national law under which the securities are constituted, require the agreement of the issuer for an acquisition to be legally effective.*
- 8) *The national law may provide for reasons which trigger ineffectiveness of acquisitions and dispositions effected under a control agreement or an agreement with and in favour of the account provider and regulate the consequences of such ineffectiveness.*

3.5.1 Questions

Q11: Would a principle along the lines described above provide Member States with a framework allowing them to determine legal effectiveness and ineffectiveness to an extent sufficient to safeguard basic domestic legal concepts, like e.g. the transfer of property?

Q12: If not, please specify how and to what extent national legal concepts would be incompatible. Please specify the practical problems linked to these background, and, if applicable, the repercussions on your business model.

3.5.2 Statistical Response

Yes	22
No	22
No clear position	29
No answer	35

3.5.3 Synthesis

73 contributors provided answers. 29 out of the 73 stakeholders who provided an answer did not provide a clear position, but provided general comments on the impact of the envisaged legislation on national law instead or specific remarks on particular paragraphs of Principle 5.

22 stakeholders confirmed that Principle 5 would allow Member States to safeguard basic domestic legal concepts. The ECB stressed that it would see merit in a higher degree of harmonisation at EU level.

However, 22 contributors disagreed and anticipated the following difficulties:

- A proposal which broke the link between credit and debit would result in a major disruption in the French holding pattern and open a path fraught with uncertainty in a domain where under the current legal system there is effectively absolute certainty (FBF, AFG, and AFTI). DAI-GDV-BDI also believed that Principle 5 was not compatible with the "no debit without credit rule" which is a fundamental legal concept in Germany.

- Principle 5 would introduce the settlement in line with the non-ownership system as the sole and mandatory concept and this would be in contradiction to basic legal concepts of the German jurisdiction where account providers further down the holding chain are not allowed to secretly “use” client ownership for their own purposes nor take pledges over them unless the owner gave its explicit approval to do so (DBB).
- It was very doubtful whether Principle 5 was compatible with
 - the provisions of the German law on the acquisition of title (where there must always be an agreement between the owner and the acquirer and a delivery, while Principle 5 provides for the original acquisition of rights along with the crediting of one account and the original loss of rights together with the debiting of another account) and;
 - the elementary principles of German civil law (which applies the principle of the prohibition of enrichment imposed on the owner against his will, while under Principle 5 the remittee can become the holder of the securities under civil law even without his consent).

DE proposed to rectify this by adopting Article 16 of the Geneva Convention.

- If the investors’ security is not protected through the right to property, an excessive and needlessly onerous guarantee system would need to be implemented by the industry (French academics).
- There may be difficulties in transposition of the new concept of “account held securities” against the background of the existing notions of “securities”, “transferable securities”, “financial securities” or a “safe custody asset” (French intermediaries, VAB).
- As there is no distinction between “disposition” and “providing security,” there may be difficulties in determination of the legal effectiveness of “acquisitions” and “dispositions” of “account held securities” versus acquisition, disposition and taking security over “securities”, “transferable securities”, “financial securities,” or a “safe custody asset” (French intermediaries, AFME, VAB, AFTI).
- Problems may arise in jurisdictions where the ultimate account holder has a property right and where the existence of fiduciary positions is not recognised (DACSI).

- Euroclear wondered how Principle 5 would apply in the French context, where accounts in the CSD do not evidence legal rights in relation to the securities held. According to French law, Euroclear France's rules determine the settlement date for a transfer of ownership but cannot determine the validity of a transfer since legal rights are not held on its books but on those of the authorized account keeper.
- In respect to English law, Euroclear observed that if Principle 5 became law, the USRs (Uncertificated Securities Regulations 2001) which govern the operation of the CREST system, would have to change. Currently they include a requirement that the CREST system must respond only to "Properly Authenticated Dematerialised Instructions" ("PADIs") which would conflict with the requirement in Principle 5 that no steps further than those set out in Principle 4 should be required to render an acquisition or disposition effective.

The following comments were made on Principle 5.6 (conditional credit):

- Some stakeholders observed that a condition can be an appropriate measure under national law in order to ensure a linkage of the separately considered elements "acquisition" and "disposition" (EACB, ZKA, Clearstream).
- Rather than "conditional credit", the wording "potential credit" should be used to make clear that it was only an announcement that subject to certain conditions being met a credit will be made (WKO, Pöch, OeKB, UniCredit).
- Principle 5.2 and Principle 5.6 are contradictory. While para 2 provides that "no further steps (...) should be required to render an acquisition or disposition effective", para 6 provides that "the effectiveness can be made subject to a condition" (French intermediaries, AFME). In order to prevent such a reading FR proposed to clarify that para 2 refers to "perfection requirements" whereas para 6 concerns the "validity requirements".
- FI stressed that it should be further clarified that Principle 5.6 only refers to the specific case of the so-called "conditional credit" and not to the general possibility of making the effectiveness of acquisitions and dispositions subject to conditions in national law.
- The exact requirements of making the condition transparent in the account should be clarified in order to allow for a uniform implementation. Conditional credit

should be made visible to the account holder by means of the account and it should not be required to describe the kind or content of the condition (WKO, Pöch, OeKB).

- Clearstream asked the Commission to consider how such transparency might be achieved by other means than technical distinguishing marks in a securities account, e.g. by specific booking codes, by contractual agreement, by operation of law, in order to address the valid concern of a significant technical as well as unnecessary financial effort.
- BE wondered whether or not the account holder was able to effect a disposition of conditional credits. On one hand, if the credit is conditional, then the acquisition is not effective and in consequence it would seem odd to consider that the conditional credits confer upon the account holder the rights set out by Principle 3. On the other hand, Principle 4.3 requires that the applicable law which allows conditional crediting should define the extent to which such conditional crediting is taken into account for determining the number of securities which are held. This would give the impression that "conditional credits" are considered as credits. BE wanted to know whether it sufficient to "mark" conditional credits as such in the account, or should national legislators in addition impose the blocking of the securities until the condition is fulfilled?
- IT proposed supplementing Principle 5.6 with the sentence: "*Conditional crediting shall not count for the purpose of Principle 4, paragraph 2*".
- The CLLS-FLC believed that conditional credits provided in support of a contractual settlement service should be confined to the account provider. In other words, there should be no on-transfer of a conditional credit to a transferee until the condition is satisfied. This is because if the account holder were to purport to settle a transaction with a third party against securities which have been conditionally credited to its account with the account provider, the account provider would be required to "lend" the required securities to the account holder to enable it to settle the transaction through the external system. In any event, CLLS-FLC did not see how the "transparency" of the condition of the credit in the account record itself could mitigate the risk that uncovered excess-securities might result from the provision of contractual settlement services. Such an operational step added cost, but it did not add anything to the substantive measures that could be taken to prevent such a result.

- Euroclear remarked that the legal effects of "contractual settlement" varied depending on the provisions of the contract between account holder and provider, but account providers should be required to ensure that the securities of one client were not used to satisfy the entitlements of another client under contractual settlement.
- NO saw conditional credits as a foreign element if the condition means lack of finality in the transfer of rights. Introducing such credits would make Settlement Securities Systems (SSSs) less certain and therefore less efficient than required by a well-functioning market.

The following comments were made on the relationship of Principle 5 with company law:

- German issuers and investors stressed that transfer of title must remain contingent upon the company's register and the applicable corporate law.
- DE welcomed:
 - Para 5, i.e. the clarification that the effectiveness of acquisitions does not determine whom an issuer has to recognise as the legal holder of its securities;
 - Para 6, i.e. the recognition of conditional credits (although it was not appropriate to say that the condition must be identifiable as such in the account, since a securities account was not a public register to which everyone has access – it must, therefore, be sufficient for the condition to be set down in law and for it to be internally identifiable);
 - Para 7, i.e. clarification regarding registered shares with restricted transferability.
- The CLLS-FLC asserted that if the envisaged legislation were to limit the ability of EUI to define the moment of "credit", then the effect of the "operational credit" of Irish securities in a CREST account would be under Principle 3.1.a to confer rights on the CREST member that it does not have under Irish company law. This would be inconsistent with Principle 1.2 that the "legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities".

- SSSA believed that the principle gave too much room for national discretion. In reference to Principle 5.5 stating that the “effectiveness in the above sense does not determine whom an issuer has to recognize as legal holder of its securities,” it asked what the situation would be if the issuer did not accept an account holder. An account provider could obviously not be responsible for a decision made by an issuer regarding the account holder’s right.

The following comments were made on the relationship of Principle 5 with the Settlement Finality Directive:

- Principle 5 should be co-ordinated with the Settlement Finality Directive because the latter had “similar provisions” (EACB, ZKA, SSSA, EAPB).
- Clearstream pointed out that Principle 5 should be without prejudice to the rules applicable to SSSs of the Settlement Finality Directive.
- The CLLS-FLC proposed that the rules of the SSS should remain free to determine what operational or other steps constitute the "credit" of securities to the relevant account. Currently, CREST rules provide that Irish securities are not "credited" to the transferee until such time as the relevant "register update request" is received from CREST by the issuer's receiving agent – which will occur, in practice, a short time after the "operational credit" of the securities to the member's account in CREST. Similar reasoning would apply to a DvP model where it is desirable to ensure that the "credit" of securities to the purchaser does not occur until the corresponding final payment occurs in favour of the seller.
- Euroclear welcomed Principle 5.3 which recognises the specific situation of SSSs by giving priority to the rules of the system to determine the consequences of an imbalance in securities held under a securities safekeeping scenario.

Stakeholder provided further comments on the practical need for the envisaged legislation or its potential impact:

- The main problems of incompatibilities between the various European markets were related to operations, market practices, non-harmonised settlement cycles and operating hours of settlement systems. Legal differences were less important, especially since the transposition of the Financial Collateral Directive (French intermediaries, German issuers and investors).

- A huge effect on the Austrian legal system (WKO, Pöch, OeKB) and other legal systems (ESBG) was expected.
- The functionality of the European account-held securities system as a whole was at stake (ZKA, FBF).
- The right to property was protected by Article 1 of the Additional Protocol to the European Convention on Human Rights and exclusion of investors' right to property would seriously penalise the European industry (French academics).
- Trades executed on a regulated market for retail clients, were usually cleared according to the netting principle by a Central Counterparty; the method currently used is based on the very efficient contractual settlement principle. Changes in legislation in this area would have major cost impact on the current business model for the entire chain (NL, DACSI, EuropeanIssuers).
- VP asked the Commission to consider introducing rules on a level playing field on treatment of the vindicated party (e.g. compensation schemes).
- Euroclear claimed that if the USRs (Uncertificated Securities Regulations 2001) were to change in order to comply with Principle 5, the balance of interests might be altered and EUI would have to consider whether it was comfortable operating the CREST system on the new basis.

3.6 Principle 6

6 – Effectiveness in insolvency

1) *Acquisitions and dispositions that have become effective under the methods described in Principles 4 and 5 should be equally effective against the insolvency administrator and creditors in any insolvency proceeding.*

2) *The Principle contained in Paragraph 1 does not affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as any rule relating to:*

(a) *the ranking of categories of claims [in the case of violation of the methods described in Principles 4 and 5];*

(b) *the avoidance of a transaction as a preference or a transfer in fraud of creditors; or*

(c) *the enforcement of rights to property that is under the control or supervision of the insolvency administrator.*

3.6.1 Questions

Q13: Would a Principle along the lines described above provide for a framework allowing effective protection of client securities in case of insolvency of an account provider?

Q14: If not, which measures needed for effective protection could not be taken by Member States under the proposed framework?

3.6.2 Statistical Response

Yes	19
Qualified yes	43
No or qualified no	0
No answer	46

3.6.3 Synthesis

It was generally acknowledged that there was a need to provide for an effective framework to protect an account holder's securities in the context of insolvency.

60 stakeholders provided responses. No one rejected the principle as a whole. 19 contributors supported the principle as it stands and 43 supported it subject to the following remarks.

There was widespread misunderstanding about the sentence "*National insolvency law often contains rules targeted at the protection of the creditors of the insolvent entity*" used in the Consultation Paper.

24 respondents interpreted the wording "creditors of the insolvent entity" as referring to the account holder and hence voiced their opposition to the assumption that securities were considered as claims (and not *rights in rem*) against the account provider. This understanding was not intended by the Commission services.

"Creditors of the insolvent entity" was meant to refer to all other creditors than the account holder.

Some respondents argued for this principle to be aligned with existing provisions of EU legislation (Article 4 para 2 sub-paragraph m of the Insolvency Regulation 1346/2000 and Article 10 para 3 sub-paragraph l of the Winding-up Directive 2001/24/EC), while others suggested that it should follow the solution of Article 14 and Article 21 of the Geneva Securities Convention more closely.

It was felt that the relationship with the Settlement Finality Directive should be dealt with in more detail. However, opinion differed on whether both solutions should be consistent or whether Principle 10 should be less generous than Article 9 para 1 of the SFD - otherwise this would dissuade participants to stay in a notified SSS. The ECB also stressed that the envisaged legislation should not prejudice the protection granted to designated systems notified under the SFD.

Some contributors felt that paragraph 2 was not clear enough; although others acknowledged that prior debates in UNIDROIT had already demonstrated the difficulty of a limitative definition.

A few southern European intermediaries voiced their opposition to control agreements being effective in insolvency proceedings if they were not known to the jurisdiction where the insolvency was opened. However, other intermediaries (a German and a European association) claimed that national insolvency law should recognize the legal position acquired under foreign law even, if it did not recognise the acquisition mechanism itself and proposed to delete Principle 6.2 (a).

Some intermediaries articulated that rules facilitating the identification of client securities would help preventing account holders' securities from falling into the insolvent estate of the intermediary. Others countered that this envisaged legislation would not be the appropriate instrument for prescribing what should be held off or on the account provider's balance sheet.

Finally, the ECB asked whether the EU framework should include a definition of "insolvency proceeding". If taken up, the definition should be a broad one and cover not only collective proceedings, including interim proceedings, aimed at liquidation of the account provider, but also reorganisation measures aimed to preserve or restore the financial situation of the account provider. To facilitate the integration of capital markets and of the post-trading activities in an internal market, the ECB would see

merit in a higher degree of harmonisation at EU level of the substantive and procedural rules in cases of any “insolvency proceeding”.

3.7 Principle 7

7 – Reversal

- 1) *The national law should ensure that book entries can only be reversed under the following circumstances:*
 - (a) *in the case of crediting provided that the account holder consents to the reversal;*
 - (b) *in the case of erroneous crediting which was not authorised by the account holder, subject to Article 9;*
 - (c) *in the case of debiting which was not authorised by the account holder, or a third person who has acquired an interest in the relevant account-held securities;*
 - (d) *in case of earmarking which was not authorised by the account holder, subject to Article 9;*
 - (e) *in case of removal of an earmarking which was not authorised by the person in whose favour it was made.*
- 2) *Paragraph 1 should be, to the extent permitted by the applicable law, subject to any rule of a securities settlement system.*
- 3) *The national law should specify the extent to which consent in the sense of paragraph 1(a) can be given in a general manner and any formal requirements for giving such consent.*

3.7.1 Question

Q14: Is the list of cases allowing for reversal complete? Are cases listed which appear to be inappropriate? Are cases missing? What are, if applicable, the repercussions on your business model?

3.7.1.1 Synthesis

64 contributors provided responses question 14. 18 respondents fully supported the list of cases for reversal as it stands while 46 stakeholders responded that the list was incomplete and/or that some elements were inappropriate.

Several stakeholders argued that the list of cases allowing for reversal should be indicative and not exhaustive (UK authorities and practitioners, Clearstream, Euroclear, Italian intermediaries) because the specific circumstances in which reversals might be necessary evolved as the market itself evolved and operational errors were, by definition, unforeseeable.

In addition, if the circumstances in which an EU account provider could reverse transactions were limited by law, then the EU account provider could be prevented from taking action to reconcile its position held at a non-EU account provider, who was not subject to such restrictions.

However, the ECB believed that the list of cases for reversal should be kept as restricted as possible owing to the severe effects of reversal, and should be harmonised at EU level to the maximum possible extent. It stressed that in the context of cross-border securities transfers, a justified reversal in one jurisdiction has the potential to put either the CSD, which has acted for the transferee, or a third party, which has acquired the securities through an onward transaction from the original transferee, at risk if the latter transaction cannot be reversed as well under the laws of the applicable jurisdiction.

The following comments were made on the existing list of cases:

- As regards **point a**, objections were raised against "*an ex ante general approval of reversal for any reason*" as it would affect the rights of other securities holders and the integrity of the system with risk of excess-securities (FR and French intermediaries, German issuers and investors), but others felt that **point a** should be extended to allow a reversal of an earmarking with the consent of the person in whose favour the earmarking was made (AT).
- Views on **point b** ranged from the attitude that book entries should not be reversed due to erroneous crediting (NO) to the opinion that erroneous crediting should be reversed irrespective of whether the account holder has authorised the crediting (SSDA). It was also pointed out that the wording "erroneous" was

superfluous as any crediting which was not authorised was erroneous (AT, BE) and that the caveat of "good faith acquisition" rule made no sense because if the crediting was not authorised by the account holder, then by definition the account holder did not "know or ought to have known that the crediting ...should not have been made" (IT).

- As regards **point c**, it was felt that reversal of a debiting should be conditioned to Principle 4, paragraph 2 – that is, to the account provider having sufficient coverage – otherwise it would amount to creation of securities (IT, KDPW).
- As regards **point d**, one respondent argued for deletion of the "good faith acquisition" caveat because they saw no reason for protecting the person in whose favour an earmarking had been made, if the earmarking was not authorised by the account holder (IT).

The following reversal events were identified as missing:

- simple "erroneous" credit,
- evident material error as per checking of the document that caused the registration,
- fraud,
- illegality,
- duress,
- undue influence,
- misrepresentation,
- unexpected technical failure of the system,
- if a debit on the sellers account has not taken place,
- under-crediting by the custodian of the account-provider,
- crediting made in conflict with Principle 4, paragraph 2,
- reversal of a earmarking with the consent of the person in whose favour the earmarking was made,
- if reversal is required or permitted by any judgment, award, order or decision of a court or other judicial or administrative authority of competent jurisdiction,

- if reversal is required or permitted by or under an enactment or any rule of applicable law,
- if reversal is required or permitted under any agreement between account holder and account provider.

The following general comments were made:

Views differed considerably on the issue whether the envisaged legislation should determine whether the effect of the reversal was *ex nunc* (Austrian WKO and OeKB) alternatively *ex tunc* (German and European intermediaries) or whether this should be left to national law (DE).

Most notably, it was claimed that the *ex nunc* solution (i.e. the book entry is initially effective) would lead to "multiplication of securities" until the date of the reversal, which could have a significant effect e.g. on the status of shareholders' rights. Some European intermediaries stressed that technical errors/systematic events should not be treated as reversals, but as non-existing transactions from the beginning.

The ECB proposed that the reversal by the system operator should have effect from the moment that it is made according to the rules of the system under national law and not retroactively, and pointed out that for reasons of legal certainty one should consider specifying a point in time after which a reversal is no longer possible. This point should be at the latest when an onward disposition has taken place. These issues (time, additional circumstances etc.) should be clear from the outset (e.g. by specification in the system rules) because these may be contentious in a crisis.

Doubts were raised as to whether Principle 7 should apply to all accounts in the holding chain. A German intermediary expressed the opinion that erroneous postings at higher custodial levels, which in his jurisdiction did not convey per se rights under the security, should be eligible for correction without the applicable requirements for a reversal being necessarily met.

Euroclear expected prices imposed by account providers on all account holders to rise in order to offset the cost of the new requirement to make reversals generally subject to the account holder's consent.

A few Nordic respondents highlighted that the rules on reversal did not account for liability and redress in the case of erroneous crediting or debiting, while

intermediaries claimed that there must be no imposition of any form of guarantee obligations on custodians.

With regard to the caveat of rules of an SSS in paragraph 2 of Principle 7, a few respondents agreed that the envisaged legislation must not interfere with the irrevocability of transfer orders and the finality of settlement effected under the Settlement Finality Directive.

In addition, stakeholders representing European Infrastructure providers proposed to define the concept of “*rules of a securities settlement system*” as including legislative as well as contractual provisions because SSSs should be entitled to continue establishing their rules, where the account provider and holder could agree on the most suitable reversal conditions.

The ECB also pointed out that it should be clarified which reversal conditions apply in case of insolvency and by whom a reversal may be decided.

3.7.2 Question

Q15: Should national law define the extent to which general consent to reversal can be given in standard account documentation? What are, if applicable, the repercussions on your business model in case your jurisdiction would take a restrictive approach to this question and limit the possibility of general consent to reversal?

3.7.2.1 Statistical Response

Yes	9
Qualified yes	26
Qualified no	3
No answer	70

3.7.2.2 Synthesis

38 contributors responded to question 15. 9 stakeholders agreed that the decision as to whether and to which extent consent to reversal can be given in a general manner should be left to Member States.

3 respondents disagreed. One stakeholder noted that leaving this question to national law would result in variable solutions which could critically undermine the approach of the envisaged legislation. 2 respondents argued that the envisaged legislation should expressly state that it was open to account holders and account providers to agree on the circumstances for reversal.

The rest of the respondents did not answer the question directly but rather focused on whether consent by the account holder to reversal should be allowed by way of contract and especially by way of the account provider's general terms and conditions.

The majority of voices saw no reason for restriction of the freedom of contract, and especially why national law should define the extent of general consent to reversal (UK and Norwegian authorities, some German intermediaries, European Infrastructure Providers).

A UK contributor pointed out that a regulated account provider would be required to conduct its business with integrity, pay due regard to the interests of its customers and treat them fairly, so that any concern that the account provider might abuse its position in relation to the account holder should be left to control through the regulatory regime. However, a Spanish infrastructure believed that the explicit and informed consent of the account holder should be required.

Many French intermediaries, issuers and investors feared that if the account holder was able to give a general consent to reversal, this would give account providers the possibility to reverse credits without sufficiently clear reasons.

Others regarded it as sufficient that Member States applied their general rules on standard documentation and the prevention of unfair terms in this field (European and Dutch intermediaries).

Among the specific comments:

- Clearstream pointed out that Principle 7.3 should make clear that it did not prejudice Principle 7.2 in order to avoid any ambiguity over SSS rules, which were standard documentation, but should be allowed to provide for suitable reversal conditions.

- European intermediaries questioned which would be the applicable law to determine the extent to which general consent to reversal could be given in standard account documentation, if this question were left to national law.
- Euroclear noticed that there was not always an agreement between an account provider and its account holder, as question 15 implied. In some Member States accounts were created by law. For example, Euroclear Sweden and its account operators did not have agreements with account holders.

3.8 Principle 8

8 – Protection of acquirers against reversal

The national law should ensure that

- (a) *an account holder is protected against reversal of a crediting;*
- (b) *a person in whose favour an earmarking has been made is protected against reversal of this earmarking*

unless it knew or ought to have known that the crediting or earmarking should not have been made.

3.8.1 Question

Q16: Do you agree with the 'test of innocence' as proposed ('knew or ought to have known')? Do you know of any practical obstacle that could flow from its application in your jurisdiction? What would be the negative consequences in that case?

3.8.2 Statistical Response

Yes	20
Qualified yes	24
No or qualified no	15
No answer	49

3.8.3 Synthesis

59 stakeholders responded to this question. 20 stakeholders agreed with the 'test of innocence' as it stands and further 24 respondents could support it subject to certain conditions. 15 stakeholders had significant concerns about the test and were therefore counted as negative answers.

It was commonly feared that a “test of innocence” would be the subject of different interpretations within different jurisdictions. The answers ranged from opinions that the phrase “ought to have known” meant slight negligence, in which case good faith acquisition would hardly ever occur (AT), to the observation that the Principle was very broad and would usually lead to acquisition in good faith (DE).

Some stakeholders regarded it as crucial for the envisaged legislation to provide some guidance that the phrase “ought to have known” did not impose any duty of inquiry or investigation which would not otherwise have existed. It was generally felt that account holders – unless acting in bad faith or gross negligence – should be able to rely on the proper working of the securities settlement.

A few respondents suggested that it should be made clear as to whether Principle 8 was intended to be a minimum or maximum harmonisation measure and opted for the former in order not to prevent Member States from extending the protection against reversal to a wider class of persons, if they so wish. Such protection would form an important part of the certainty and finality in relation to settlement.

For the sake of consistency the alignment with the corresponding Article 18 of the Geneva Securities Convention was requested several times. It was proposed to follow the wording of Article 18.1, i.e. “actually knows or ought to know, at the relevant time”, to determine the legal consequences of the protection in more detail, as sub-paragraph a-c of Article 18.1 did, and to exclude gifts and other gratuitous transactions in conformity with Article 18.3.

Views varied whether Principle 8 should aim at protecting the acquirer against the effect of earlier defective entries, as 18.2 Geneva Securities Convention expressively did. German issuers and investors, UK authorities and intermediaries felt that the good faith purchaser must be protected above all, and if he is protected, earlier defective entries may not be reversed. However, this solution was regarded by other stakeholders as leading to a multiplication of securities.

The EDCB agreed with the principle that only good faith acquirers should be protected and not any person who knows (or ought to have known) that it has no right to acquire.

In order to protect the integrity of the issue, some proposed to create a mandatory link between the acquisition and the loss of a title (DE). The idea to differentiate between "credits" and "fictitious positions" (i.e. a situation when account held securities were not covered by a corresponding number of securities of the same description held by the account provider) and determine that "good faith acquisition" regarding "fictitious positions" was not possible found broad support (German, Austrian and European intermediaries as well as issuers and investors).

It was generally felt that the envisaged legislation should include additional guidance outlining how the concepts concerning a reversal (Principle 7) and the protection of acquirers against reversal (Principle 8) interrelated, especially whether they were to be considered independently or as complementing each other. By the same token, the interrelation between these Principles and the uniform rules of an SSS (with regard to Article 18.5 Geneva Securities Convention) should be clarified.

Opinions differed on how to deal with potential liability issues arising out of the envisaged limitation to reverse an erroneous credit in the case of good faith acquisition. Some claimed that Principle 8 would introduce a no-fault liability standard for account providers, which would adversely impact credit lines and risk profiles and could lead to increased systemic risk in periods of market stress (AGC).

Others proposed introducing a liability regime (civil or criminal) applicable to those who refused the reversal in wilful misconduct (BME). The Commission was also asked to consider introducing rules on a level playing field on treatment of the vindicated party, e.g. compensation schemes (VP).

3.9 Principle 9

9 – Priority

- 1) *The national law should provide that Priority rules prescribe that*
 - (a) *interests in the same account-held securities which are acquired by earmarking rank amongst themselves in chronological order;*
 - (b) *interests in the same account-held securities which are acquired by control*

agreement or an agreement with and in favour of the account provider rank amongst themselves in chronological order;

(c) interests in account-held securities which are acquired by earmarking have priority over interests acquired in the same account-held securities by means of a control agreement or an agreement with and in favour of the account provider.

2) An acquisition of securities, account-held securities or interests therein effected under Principle 4 should prevail over any other method permitted by the national law.

3) Parties should be able to deviate from the above rules by agreement. Such agreement cannot affect the rights of third parties.

4) Security interests or other limited interests created by mandatory operation of the applicable law should have the priority attributed by that law.

3.9.1.1 Question

Q17: Will a Principle along the lines set out above, under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not 'visible' in the relevant securities account? If not, please explain why.

3.9.1.2 Statistical response

Yes or qualified yes	27
No or qualified no	25
No answer	56

3.9.1.3 Synthesis

52 contributors provided a response to question 17.

The contributors were clearly polarised. The proponents for giving control agreements an inferior priority argued that:

- Control agreements would need an inferior priority because they did not appear in the account and in case of insolvency the insolvency administrator would need to verify the contracts in order to determine the insolvent intermediary's estate. This could be done easier and quicker if all types of interests in securities were reflected in the account.
- A control agreement was not an objective method such as debit, credit and earmarking because its features depended on the subjective will of the involved parties.
- Book entry methods were external manifestation of the disposition. This act of publicity was sufficient and adequate to give the holder priority over other holders of rights on the same book entry securities which have not been subject to an external act manifesting their interest in the said securities (e.g., a control agreement). The ECB noted that this "visibility" facilitates allocating positions and possibly transferring positions from a member to another in case of failures.
- Control agreements were not common in all European jurisdictions.
- It was unclear how the participants of a holding chain received information about a control agreement or about its content, if the right governed by a control agreement did not appear either on the security itself or on the security account.
- Legal effects derived from non book-entry methods should be as limited as possible. In this respect, the agreements signed by the contracting parties should be considered as the reason for a transfer between the parties, but all the legal effects of the transfer before third parties should only be obtained by means of the relevant book-entry in the securities' accounts.
- One could envisage quite serious negative consequences and an unjustified privilege of an account provider, if control agreements which are not "visible" in the relevant securities account were given priority over interests created on another basis and visible in the relevant securities account.

It should be noted that of the 27 proponents of the solution envisaged by this Principle, 10 contributors proposed a caveat in favour of CSDs who

1. fulfilled the central settlement function, and;

2. needed control agreements in order to facilitate the settlement process in the declared system under the Settlement Finality Directive.

The opponents argued that:

- Principle 9 would render all other interests largely worthless because there would always be the risk that an interest created later in time could take priority over an interest created earlier that was not acquired by means of earmarking. Subordinating a method to others would be tantamount to abolishing the former.
- Preventing existing and well established national methods on which market participants relied from being used in future would be to throw the baby out with the bathwater.
- There would need to be complex transitional provisions in the envisaged legislation dealing with security interests created prior to their coming into effect. As regards the content of such rules, it was urged that any existing collateral arrangements which might not be compatible with the prescribed methods under the envisaged legislation, should be grandfathered into the new regime. Otherwise additional costs would be involved.
- It was doubtful whether any book-entry system was transparent for others than the account provider. The concept of transparency in relation to records which were neither maintained in physical form nor open to investigation by interested third parties was artificial. A securities account was not a public register to which a potential collateral taker could have access. For that reason it was problematic to justify the inferior priority for a control agreement on the ground that book-entry systems were transparent.
- Interests created under a control agreement were no less transparent to third parties than earmarking. Where a third party was contemplating advancing credit to an account holder on the security of an interest in intermediated securities, that third party should have a means of satisfying itself that there was no existing prior interest. However, the only way in which the prospective creditor could satisfy itself was by enquiring of the relevant account provider. Such an enquiry would reveal a prior interest whether it had been perfected by earmarking or by a control agreement (since an agreement of which the account provider was unaware would not be a “control agreement” as defined).

- The effect of a security interest and the degree of control exercised by the collateral taker might be even greater in the case of control agreements than earmarking. As currently proposed, earmarking rules did not require prior notification to the account holder, in contrast to the proposals regarding control agreements. Principle 9 afforded priority to a subsequent earmarking, irrespective of whether the earmarking was entered into by the collateral taker with direct knowledge of an existing control agreement. This could lead to a perverse outcome in which an account provider (acting in collusion with the collateral taker) would be able to fraudulently enter into an earmarking arrangement which bestowed priority over an existing control agreement. These concerns were exacerbated in a chain of intermediaries, where the envisaged legislation would allow upper-tier intermediaries to earmark the securities to the detriment of lower-tier intermediaries and their investor clients.
- There was no similar distinction made in Articles 19 and 20 of the Geneva Securities Convention. The envisaged European legislation should aim at promoting international harmonisation and refrain from giving an inferior ranking to interests perfected by control agreements.

Of the 25 opponents to the solution envisaged by Principle 9:

- 13 contributors proposed to base the envisaged priority rule on the chronological order of creation of the security interests,
- 7 respondents suggested to leave to Member States the discretion to determine the priority between earmarking and control agreements, and;
- 3 respondents argued with reference to Article 20(2) Geneva Securities Convention that if a subsequent earmarking arrangement was to be given general priority over a control agreement, that priority should be lost if it was taken with knowledge that it breaches the rights under a control agreement.

With regard to other comments made, the following are worth noting

It was pointed out that the priority rules of the envisaged legislation must not conflict the Financial Collateral Directive. To the extent that interests were created under the envisaged legislation and were to be characterised as financial collateral, such interests should – regardless of the method of creation – have priority over

corresponding creations of an interest outside the scope of the FCD. Otherwise confusion and complication in taking collateral would arise.

Several contributors could not understand why "crediting and debiting" were not within the scope of the priority provisions.

As regards Principle 9(3), the Nordic Financial Union endorsed that the principle of contractual freedom of the parties, allowing for changes in the order of priority, must not affect the rights of third parties, above all the employees of a failing credit institution.

There was a lack of clarity as to what constitutes an "earmark" and how that should be manifested operationally, e.g. whether the entry must appear in the designation of the account and at what level would it need to be effectuated.

Whilst earmarking at account level was regarded by some intermediaries as requiring minor operational and systemic amendments, earmarking at an ISIN level would involve major re-engineering of the credit engine, custody platform and process flows across different markets.

It was felt that as a result of the envisaged legislation, collateral takers would be required to carry out legal due diligence in all relevant jurisdictions in order to determine whether earmarking did indeed have the prescribed effects. It would be helpful if the Directive would set out specific rules and guidelines to make the existence of earmarking operationally ascertainable without recourse to legal advice.

Clarification was also requested as to the duties of an account provider where securities (or an account) had been earmarked for a particular collateral taker.

3.9.2.1 Question

Q18: Have you encountered difficulties regarding the priority/rank of an interest created under a mechanism comparable to a control agreement in the context of a priority contest, or, more generally, in an insolvency proceeding? If yes, please specify.

3.9.2.2 Statistical Response

Yes	0
Qualified yes	0
No or qualified no	22
No answer	86

3.9.2.3 Synthesis

22 stakeholders provided responses to this question. None reported experiencing difficulties regarding the priority of an interest created under a control agreement. Instead, they answered the question by actively endorsing that they have never encountered practical difficulty with the operation of control agreements.

3.9.3.1 Question

Q19: Would there be negative practical consequences for your business model flowing from a Principle along the lines set out above? If yes, please specify.

3.9.3.2 Statistical Response

Yes	13
No or qualified no	3
No answer	92

3.9.3.3 Synthesis

16 stakeholders provided responses. 1 contributor envisaged no negative effects for its business model. However, 15 stakeholders provided, extensive explanations why Principle 9.1 sub-paragraph c would have negative consequences for their business.

These comments can be summarized as follows:

- If **control agreements** were given a lower priority by the envisaged legislation, then the use of account-held securities as collateral in the UK financial market would only be possible through other methods than the "floating charge", which

would inevitably have negative implications not just in terms of higher transaction costs for CREST members, but it would also require changing well-established procedures which worked (costs for developing a new operational solution were assessed by Euroclear as running into several million pounds). The current practice in the CREST system was that each CREST member was required to have a settlement bank to make and receive payments in CREST on its behalf. The settlement bank controlled its exposure to the CREST member by setting a cap on the intra-day credit it provided to that member and some CREST members were permitted to increase the amount of intra-day credit they were given by granting a security interest to the settlement bank, referred to in English legal terms as a "floating charge", over the securities in their CREST account. This floating charge was created by means which would constitute a "control agreement" under the envisaged legislation. So, if Principle 9 undermined the effectiveness of this protection by subordinating interests created by control agreement to those created by earmarking, this would have significant detrimental impact on the level of liquidity granted by settlement banks to CREST members and a devastating effect on the UK market generally (for further details and data see the responses by UK authorities, Euroclear, Financial Law Committee of City of London Law Society, UK Payments).

- Rendering an **agreement with and in favour of the account provider** junior by the envisaged legislation would devalue a "lien stipulated in the general terms and conditions" used e.g. in German banking practice to collateralise all of the bank's existing as well as future claims against its account holders arising from the business relationship between the two parties (*AGB-Pfandrecht*). The European banking industry (EACB, ZKA) expects that this would exacerbate the accommodation of loans because prior to entering an earmark in favour of the grantee of a bank's account holder, the bank would always need to review whether to create an earmarking interest to itself in its own favour or leave matters with its then subordinate "general terms and conditions lien". The International Securities Lending Association expected negative consequences for agent lenders, such as custodians, who also took a lien or security interest over their clients accounts to secure performance of their obligations. The effect of the proposal could be to adversely impact the credit protection taken by such agents particularly in respect of collateral that may be held in a tri-party structure or in a third party lending arrangement.

3.10 Principle 10

10 – Protection of account holders in case of insolvency of account provider

- 1) *The national law should ensure that In the event of insolvency of the account provider securities and account-held securities held by the account provider for its account holders should be unavailable for distribution among or realisation for the benefit of creditors of the account provider.*
- 2) *The national law applicable in the insolvency of an account provider should provide for a mechanism governing the distribution of the shortage in the event of an insufficient number of securities or account-held securities in the sense of Principle 4 paragraph 2 being held by an insolvent account provider.*

3.10.1.1 Question

Q20: Would a Principle along the lines described above pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?

3.10.1.2 Statistical Response

Yes	11
Qualified yes	50
No	3
No answer	44

3.10.1.3 Synthesis

64 stakeholders provided responses to this question. 3 contributors claimed that the effectiveness of the Principle would depend on a higher level of harmonisation. However, the vast majority of responses agreed with the principle. 11 proponents provided a simple "yes" while 50 contributors could support the Principle subject to some changes. Many respondents stressed that the two elements of this Principle

are among the most important elements that the proposed legislation should embody.

As regards the first paragraph of Principle 10 that account-held securities held by an account provider for its account holders should be protected from the insolvency of the account provider, the majority of contributors pointed out that this principle was already reflected in the laws of their respective jurisdictions. However, a greater clarity as to the existence and operation of such a principle in all the Member States was regarded as helpful in order to ensure the integrity of systems for the intermediation of securities holding.

In order to make this rule effective some stakeholders proposed introducing rules aimed at facilitating the identification of client securities. While some argued for introducing rules requiring a clear segregation of client holdings from securities held by the account provider for its own account (ECB, Computershare, Equiniti, ICOSA), others stressed that under the MIFID rules, client's securities should already be segregated from the investment firms (ABBL).

The question was raised (Euroclear) as to what categories of securities were caught by this Principle, i.e. whether it extended beyond securities in which the account provider retained a proprietary interest and securities held in designated client accounts.

As regards paragraph 2 aimed at providing for a mechanism governing the distribution of the shortfall in the event of an insufficient number of securities held by an insolvent account provider, views differed on the degree of harmonisation needed.

FI and Swedish intermediaries felt that more far-reaching efforts to harmonise the legal framework for the client securities in insolvency situations would be desirable, others, especially French authorities and intermediaries, proposed to harmonise the loss sharing methods, but to leave the regulation of the loss sharing itself to Member States, while others (Germany and European intermediaries associations) supported the Principle as drafted. An Infrastructure provider welcomed that no rule was intended to the respect that securities held by an account provider should be attributed to its account holders in the event of the former's insolvency.

3.10.2.1 Question

Q21: If not: Which mechanisms should be available which could not be implemented under a framework designed along the lines described above. Please specify.

3.10.2.2 Synthesis

Only a few respondents made substantive comments to question 21 by answering that the following mechanisms could be envisaged (admittedly without claiming that these mechanisms could not be implemented under a national framework designed along Principle 10):

- The solution on preferential treatment of account holders provided by Section 32 of the German Securities Deposit Act (quoted in the response of ZKA). In this context it is also to be noted that some French intermediaries (SGSS), issuers and investors (AFG) as well as securities professionals (AFTI) presented the view that securities held by the insolvent account provider for his own account should be attributed as a matter of priority in shortfalls of client securities. However, others claimed that any compensation regime for account holders must respect the protection of the employees of a failing credit institution (NFU).
- Monetary damages for all account holders pro-rata as insolvency claim (EACB, EAPB).
- Harmonised time period for an insolvency receiver to determine if the insolvent estate holds enough securities to satisfy all claims from account holders (EACB, EAPB).
- Harmonised rule on if the disposition/transfer of securities should be barred until the insolvency receiver had time to determine if the insolvent estate holds enough securities and if not what the consequence for those account holders should be who do not transfer the securities to another account provider (EACB, EAPB).

3.10.3.1 Question

Q22: Should the sharing of a loss in securities holdings (occurring, for example, as a consequence of fraud by the account provider) be left to national

law? Would you prefer a harmonised rule, following the *pro rata* principle or any other mechanism?

3.10.3.2 Statistical Response

Yes	18
Qualified yes	2
No	20
No answer	68

3.10.3.3 Synthesis

Out of 40 stakeholders who provided a response to this question, the *pro rata* principle was supported by 18 stakeholders. 19 respondents objected the *pro rata* principle and 2 responses developed a combined approach.

Overall, the *pro rata* loss sharing mechanism met with strong opposition, especially from the German stakeholders (authorities, majority of issuers and investors, a consumer association and an intermediary). It was claimed that the risk of intermediaries related to shortfalls could be eliminated if the "no credit without debit rule" was enshrined. In that case an allocation mechanism would be relevant only, if an illegal shortfall occurred.

However, a UK stakeholder claimed that distribution on the basis of tracing rules would be complex, expensive to apply and would produce incidental winners and losers amongst account holders. It was pointed out that the UK is currently contemplating a *pro rata* loss sharing rule in Section 12 para 2 of the draft Investment Bank Special Administration Regulations. Among the supporters of a *pro rata* rule are some Scandinavian stakeholders (2 authorities and an intermediary), 3 Infrastructure providers (Clearstream, OeKB, KDPW), some French intermediaries as well as ISDA. Helix remarked that the application of the *pro rata* principle presupposed the existence of indirect holding patterns and its appropriateness was in this case indisputable. It was however questionable whether *pro rata* rules could be applicable in case of direct holding, i.e. regular deposits.

Similarly, the ECB remarked that the degree of transparency and tracing of shortages to a specific account holder might vary depending on the respective holding structure and the account level. According to the ECB it was very important for customer protection in an internal EU market that EU law provided for a general rule of segregation of client securities from own assets of intermediaries, for any products in the different holding structures.

Furthermore, the Commission Services were advised to check the interlinks with other European legislative acts, such as the Investor Compensation Schemes Directive 1997/9/EC, the Alternative Investment Fund Managers Directive (Council Doc. 15053/1/10 REV 1) and the future UCITS V Directive (see Consultation Paper on the UCITS Depository Function and on the UCIT Manager's Remuneration). The two latter directives will address the issue of liability of account providers who are fund depositories.

3.11 Principle 11

11 – Instructions

- 1) *An account provider should neither be bound nor entitled to give effect to any instruction in relation to account-held securities of an account holder given by any person other than that account holder.*
- 2) *Paragraph 1 is subject to:*
 - (a) *any agreement between account holder and account provider;*
 - (b) *the rights of any person, including the account provider, who has acquired an interest in the relevant account-held securities;*
 - (c) *any judgement, award, order or decision of a court or other judicial or administrative authority of competent jurisdiction;*
 - (d) *any judgement, award, order or decision of a court or other judicial or administrative authority of competent jurisdiction;*
 - (e) *if the account provider is the operator of a securities settlement system, the rules of that system, to the extent permitted by the law governing the system.*

3.11.1 Question

Q23: Would a Principle along the lines described above provide for a framework allowing the national law to effectively apply restrictions on whose instructions to follow for purposes of investor protection, notably in connection with the envisaged Principle contained under section 4 (Paragraph 2)? If not, please explain why

3.11.2 Statistical Response

Yes	27
Qualified yes	30
No or qualified no	2
No answer	49

3.11.3 Synthesis

59 stakeholders provided responses to question 23. 27 stakeholders agreed with Principle 11 as it stands and further 30 respondents could support it subject to certain conditions. 2 contributors doubted whether this principle was really necessary and were therefore counted as negative answers.

Several respondents asked to clarify in the text that where the rights to which only the ultimate account holder was entitled, only the instructions of the ultimate account holder were authoritative. It was claimed that failing the end investor's instruction, an upper-tier intermediary (or intermediary of the upper-tier intermediary) might not provide instructions related to the rights flowing from those securities. If an end investor did not exercise rights, those rights should expire and not be exercised by intermediaries.

The Commission was also asked to check the interaction of Principle 11 against other provisions of the envisaged legislation, e.g. how the requirement for account providers to follow instructions exclusively from the account holder would operate in relation to the regulation of shared functions under Principle 3.

Several stakeholders proposed to clarify in the text that the account holder can give instruction through a representative with the necessary power of attorney, one

respondent recommended to clarify that the insolvency practitioner was able to give instructions and another one suggested to include a positive obligation for account providers to give effect to instructions of account holders in the ordinary course of business.

As regards Principle 11.2 sub-paragraph d, concerns were voiced that the applicable law of the account provider might conflict with the law governing a CSD in which the securities were held by the account provider. In the view of a European Infrastructure provider it would be in the interest of the proper functioning of SSSs, if the rules of a CSD or SSS prevailed.

Several contributors saw no justification for Principle 11.2 sub-paragraph e. Some read the provision as allowing the operator of a SSS to refuse the execution of an instruction, while the participant to that system was obliged to execute the instruction given by its client. Others claimed that sub-paragraph e intended to make instructions of the end investor conditional on the general terms and conditions of a CSD which would unilaterally abolish any investor protection.

3.12 Principle 12

12 – Attachment by creditors of the account holder

The national law should provide that creditors of an account holder may attach account held securities only at the level of the account provider of that account holder.

3.12.1.1 Question

Q24: Would a Principle along the lines described above provide Member States with a framework allowing them, in combination with the envisaged Principle on shared functions, to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.

3.12.1.2 Statistical Response

Yes	38
No or qualified no	20
No answer	50

3.12.1.3 Synthesis

58 contributors responded to question 24. 38 could support Principle 12 as it stands. The ECB stressed that this principle was fundamental to the integrity of the system of multi-tiered holding of intermediated securities and that including a harmonised rule to this effect would be in the interest of greater legal certainty and investor protection. However, 20 stakeholders found that Principle 12 would either not allow Member States to effectively reflect operational practice regarding attachments or voiced other reservations:

- It is doubtful whether this rule is really sufficient to give certainty in a cross-border context, in particular in a chain of accounts holding foreign securities (EBF, SSDA).
- In national legal systems the ownership rights (full ownership, co-ownership, legal ownership or beneficial ownership) appear only in one given securities account in the securities holding chain. A rule, which explicitly prohibits upper-tier attachments, seems appropriate in a legal system where securities are considered as claims against the account provider and therefore appear on several levels of the holding chain per issued security (French intermediaries).
- Similarly, FR considered Principle 12 as being very problematic and proposed the following redrafting: “*The national law should provide that creditors of an account holder may attach securities only on the securities accounts where that account holder acts as ultimate account provider of that account holder with regard to these securities*”.
- DBB suggested adjusting Principle 12 to: “*Creditors of an owner/investor may only attach at the level of the owner’s/investor’s account provider*”.
- Euroclear urged that the protection to settlement systems against attachments afforded by Belgian law (attachment is not allowed on account opened with the

settlement system) and French law (prohibits attachment of accounts maintained by a CSD) should be preserved.

- ABI found that there should be a segregation of assets not only between the assets of the account holder's and intermediary's but also between the assets of the clients' of the same intermediary.
- There was concern that the transparent holding concept was not properly understood (Helix, Euroclear).

It should also be noted that in reference to Article L211-4 of the French Monetary and Financial Code (which provides that a securities account is opened in the name of the owner of the securities and which is regarded as the provision determining the account where attachments are able to be realised) 12 French intermediaries urged the Commission to create a declarative system by which Member States would notify the Commission of the account in the chain where ownership rights appear which may therefore be attached.

Finally, NASDAQ OMX made several suggestions to facilitate expeditious attachment of ultimate account holder's assets, i.e. by obliging account providers to keep certain data about investors and give certain information about their holdings and account records to public authorities such as courts and bailiffs. They also proposed to extend the scope of "attachment immunity" to fruits and benefits flowing from account-held securities such as dividends.

3.12.2.1 Question

Q25: Have you ever encountered, in your business practice, attempts to attach securities at a tier of the holding chain which did not maintain the decisive record? If yes, please specify.

3.12.2.2 Synthesis

Only two respondents encountered attempts to attach securities at a tier of the holding chain which did not maintain the decisive record. (EAPB, EBF).

The following comments were also made:

- EBF confirmed cases where there have been difficulties to achieve a secure and effective attachment recognised at the account provider level.
- There had been theoretical considerations of investors to attempt to attach securities at the level of the Austrian central securities depository in connection with Argentine bonds, but no such court cases (OeKB).
- Although no such attempts were identified by CLLC-FLC, its member firms had occasion to advise clients in circumstances on the possibility of such an attempt. They considered that, although the risk of such an attempt being successful is small, the damage that would be caused if it were successful even for a short time and the residual uncertainty arising from such a possibility are serious enough to make a provision along the lines suggested highly desirable.
- DAI-GDV-BDI explained that they had no first-hand experience with such attempts because German law provided for the end investor having co-ownership in the security thereby safeguarding his rights. If such a rule was changed, this would cause several problems, one of which was attempts of persons to attach securities at another tier of the holding chain.
- BME pointed out that the blockage of the relevant nominal account at the central level might be due to actions of creditors who are beneficiaries of pledges and of other forms of collateral over such securities.

3.13 Principle 13

13 – Attachment by creditors of the account provider

The national law should prohibit that creditors of an account provider attach securities credited to accounts opened in the name of that account provider with a second account provider, as far as these accounts are identified as containing securities belonging to the first account provider's customers. Where the law provides for a presumption that accounts opened by an account provider with a second account provider contain securities belonging to customers, the presumption should apply.

3.13.1.1 Question

Q26: Would the proposed framework for protecting client accounts be sufficient?

3.13.1.2 Statistical Response

Yes	21
No or qualified no	8
No answer	79

3.13.1.3 Synthesis

29 contributors provided response to question 26. 21 found Principle 13 sufficient for protecting client accounts. However, 8 stakeholders regarded Principle 13 as being inappropriate because:

- It was preferable if attachments of accounts held by an entity which is itself entitled to provide accounts were forbidden unless the holdings of such entity were earmarked as own assets (DBB).
- Marking of accounts should be prescribed so as to make clear which account is opened for the 'ultimate account holder' and which is opened for 'non-ultimate account holder' (NASDAQ OMX).
- Segregation of assets should be introduced as a rule (KDPW, ABI, CONF.2, EuropeanIssuers).
- It would be necessary for the laws of different Member States to recognise the effectiveness of non-segregated accounts and fiduciary positions of account holders (EBF).
- The proposal as currently formulated would be wider than it is necessary to achieve the objective to protect investors against attachments attributable to the obligations of account providers (AGC). In order to ensure the smooth functioning of securities settlement by providing credit to account holders, account providers typically take some form of rights (lien, security interest etc) in relation to securities credited to client's account in order to manage the risk stemming from such obligations. If denial of this basic method of protection against credit risk

were to be entrenched in legislation, the consequence would be that custodians might well reduce credit availability, with undesirable consequences in terms of the liquidity of cash available to portfolio managers as well as the liquidity of securities markets. Alternatively, systemic risk would increase as account providers would need to set aside more capital against increased unsecured exposures necessary to support the same activity.

In addition, NASDAQ OMX proposed to provide for a catalogue of extra obligations for the trustee in the insolvency proceedings of an account provider in order to ensure that minimum set of services continues to be available to account holders so as to enable them to re-arrange holding of their assets.

3.13.2.1 Question

Q26: Should the presumption that accounts opened by an account provider with another account provider generally contain client securities become a general rule? If not, please explain why.

3.13.2.2 Statistical Response

Yes	26
No	8
No answer	74

3.13.2.3 Synthesis

34 stakeholders responded to the question as to whether the presumption should become a general rule. 26 responded in favour of the introduction of a presumption that accounts opened by an account provider with another account provider generally contain client securities. However, 8 stakeholders found that no such presumption should be introduced because:

- It would be too far-reaching (FI). While such a rule would indeed offer strong protection for a certain class of investors, it could be detrimental to others (i.e. those that fall to the category of the so-called general creditors of the account provider).

- Converting certain national particularities into a general rule would distort the functional approach and would create a burden of proof on the upper tier account provider (BME).
- In jurisdictions where there is effective segregation between 'client' and 'proprietary' assets, introducing a general presumption would create legal uncertainty over the effectiveness of existing mechanisms, which may not be explicitly documented, but which would nevertheless be legally robust as things stand (CLLS-FLC).
- Such a presumption does not accord with market practice in all Member States. For example in Sweden nominee accounts have to be flagged as such, and it thus explicitly clear that they contain only client assets, which may be a far more effective method of client protection (Euroclear).

3.14 Principle 14

14 – Determination of the applicable law

- 1) *The national law should provide that any question with respect to any of the matters specified in paragraph 3 arising in relation to account-held securities should be governed by the national law of the country where the relevant securities account is maintained by the account provider. Where an account provider has branches located in jurisdictions different from the head offices' jurisdiction, the account is maintained by the branch which handles the relationship with the account holder in relation to the securities account, otherwise by the head office.*
- 2) *An account provider is responsible for communicating in writing to the account holder whether the head office or a branch and, if applicable, which branch, handles the relationship with the account holder. The communication itself does not alter the determination of the applicable law under paragraph 1. The communication should be standardised.*
- 3) *The matters referred to in paragraph 1 are:*
 - (a) *the legal nature of account-held securities;*
 - (b) *the legal nature and the requirements of an acquisition or disposition of account-held securities as well as its effects between the parties and against third parties;*

- (c) *whether a disposition of account-held securities extends to entitlements to dividends or other distributions, or redemption, sale or other proceeds;*
 - (d) *the effectiveness of an acquisition or disposition and whether it can be invalidated, reversed or otherwise be undone;*
 - (e) *whether a person's interest in account-held securities extinguishes or has priority over another person's interest;*
 - (f) *the duties, if any, of an account provider to a person other than the account holder who asserts in competition with the account holder or another person an interest in account-held securities;*
 - (g) *the requirements, if any, for the realisation of an interest in account-held securities.*
- 4) *Paragraph 1 determines the applicable law regardless of the legal nature of the rights conferred upon the account holder upon crediting of account-held securities to his securities account.*

3.14.1.1 Question

Q27: Would a Principle along the lines described above allow for a consistent conflict-of-laws regime? If not: Which part of the proposal causes practical difficulties that could be addressed better?

3.14.1.2 Statistical Response

Yes	10
Qualified yes	52
No or qualified no	15
No answer	31

3.14.1.3 Synthesis

77 stakeholders responded to this question. 15 respondents were opposed to Principle 14 because they either argued for the ratification of the Hague Securities

Convention or expected practical difficulties due to the asserted lack of legal certainty introduced by this conflict-of-law rule.

10 contributors supported the Principle as it stands while 52 others could support the introduction of a conflicts-of-law regime subject to conditions. 11 respondents even went so far as to say that the conflict of law rule appeared to be the major justification for the envisaged legislation.

The main points as regards Principle 14.1 can be reflected as follows:

As regards the connecting factor, most respondents were in favour of the Commission's proposal to use the already existing "Place of the Relevant Intermediary Approach" (PRIMA). The next most popular alternative, the Hague Convention approach which allows for (certain degree of) party autonomy had a polarising effect. A third option based where the home state of the relevant issuer/the state under the laws of which the securities were constituted was also proposed.

Views differed considerably on the second sentence of paragraph 1, which was commonly regarded as being unclear. Some of those contributors, who supported the PRIMA rule, argued that it should be read only as the place in which the intermediary's branch that handles the relationship with the account holder was located because only this solution would meet the reasonable expectations of the account holder.

However, others argued for the account provider's head office (AFME), i.e. as being the nexus in line with the Winding-up Directive (under which a failing credit institution with branches in different Member States was subject to a single bankruptcy proceeding in the home State where it had its registered office).

But some felt that this would endanger the final investor's rights since he might not even know where such head office was located (VAB), while others feared that any reference to the intermediary's head office or the second sentence of paragraph 1 as such would amount to freedom to choose the applicable law (FR, German and French issuers and investors).

Practical difficulties in identifying the branch that handles the relationship were regarded by many practitioners as being so important that they ruled out this connection as being able to provide the degree of legal certainty a conflict of law rule needed.

Some highlighted that the nature of an account relationship was an intangible one, and that relying on one or more aspects of the operation of an account provider (e.g. the location of branch building, location of office where personnel are located who manage the account relationship, location of call centre, location of corporate headquarters of the account provider, location of relevant systems infrastructure) over others would artificially locate an intangible relationship.

Furthermore, the physical aspects related to a single account provider would evolve over time as operations develop, including the evolution of shared functions and the advancement of technology. These difficulties lead several stakeholders to the conclusion that sentence 2 of paragraph 1 should be deleted.

However, some proposals were also made on how to tackle the issue. For example, BE suggested introducing a limited number of conditions that must be fulfilled cumulatively in order to reverse the presumption that the account is maintained at the head office.

Meanwhile, NE suggested using in the second sentence of Paragraph 1 wording similar to Article 19.2 of the Rome I Regulation (*"Where the contract is concluded in the course of the operations of a branch, agency or any other establishment or performance under the contract is the responsibility of a branch, agency or other establishment, the place where that branch or agency or establishment is located shall be the place of habitual residence"*).

Others suggested continuing to use Paragraph 2's approach, but to provide that the communication should be conclusive as against and for the benefit of the account provider and any third party who relied on it (CLLS-FLC).

Possible fraudulent actions of account providers "re-locating" their account relationships could be resolved by the imposition of regulatory sanctions. Another means of resolution (DE) or an additional element to increase global compatibility (ECB) would be to introduce an identification number for securities accounts.

The following comments were made on Principle 14.3:

- It was claimed that it covered matters pertaining to the securities ownership regime normally falling within the ambit of the applicable corporate law (German issuers and investors).
- The relationship between Principle 14.3.a and Principle 3.1.a was questioned (IT).

- NASDAQ OMX remarked that company law sometimes provides for restrictions on the free disposition of securities (e.g. right of pre-emption of shares) and wondered which law would be applicable to legal consequences where dispositions are made that are in conflict with such restrictions.
- Principle 14.3.c should be read without prejudice to corporate law (SE).
- A proposal was made to add to the list "*revindication rights of the account holder in case of insolvency of its account provider vis-à-vis a third party account provider, and the effects of control agreements*" (BE).

Among other comments, one may note:

- The observation was repeatedly made that a transfer of account held securities affected two ultimate account holders and hence two securities accounts, where the securities accounts might be maintained in different countries.

Because the envisaged legislation designed acquisition and disposition of securities as two situations legally independent from each other, the facts constituting the disposition might be evaluated under a different legal system (nexus to the “seller’s” securities account) than the facts constituting the acquisition (nexus to the place of the acquirer’s securities account).

- There were doubts as to whether Principle 14 specified only the law of a Member State or all jurisdictions. French intermediaries and NE claimed that it should be restricted to Member States only.
- A suggestion was made to make the relevant point in time for the purpose of determining the applicable law clear (i.e. to clarify if the relevant jurisdiction was intended to be identified once and for all, or whether it should be amenable to changes over time, in case a customer switched to another branch).
- It was pointed out that the conflict of law rule should be uniform and therefore be adopted by means of a regulation (NE, VAB). The ECB proposed to place such a conflict-of-law rule within the Rome I Regulation on the law applicable to contractual obligations.
- Several respondents asked that the interaction with other European legislation in the field on conflicts of laws be considered, i.e.:
 - Regulation on insolvency proceedings,

- Rome I Regulation,
 - Financial Collateral Directive,
 - Settlement Finality Directive,
 - Winding-Up Directive.
- Serious doubts were raised by several UK stakeholders as to whether Principle 14 was appropriate for both indirect holding and direct holding/transparent systems - in particular the CREST system in respect of securities issued under the law of Ireland, Jersey, Guernsey and the Isle of Man. Having regard to Article 1(5) of the Hague Convention, the CLLS-FLC proposed to add the following paragraph: *"This Article does not apply to account-held securities credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such account-held securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer"*.

3.14.2.1 Question

Q28: Would the mechanism of communicating to the client, whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to *ex-ante* clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?

3.14.2.2 Statistical Response

Yes	10
No or qualified no	33
No answer	65

3.14.2.3 Synthesis

43 stakeholders provided a response to this question. 10 respondents supported paragraph 2 of Principle 14 as it stands.

33 stakeholders rejected the mechanism of communicating to the account holder because:

- Requiring that an account provider informs the customer where the account was maintained, i.e. which law is applicable, hardly served legal certainty if this communication was to remain legally non-binding. Instead, it would provide an additional layer of uncertainty.
- As the account holder or any interested party had no real means of verifying whether this communication was correct, it might suffer material loss if this subsequently proved to be incorrect.
- Making such communication legally binding would mean moving away from an objective connecting factor and would be tantamount to introducing party autonomy.
- The mechanism would impose additional formality and expenses on all account providers in the EU, even if they have only a domestic office. This would be disproportionate.
- Third country account providers could not be covered by the rule on communication.
- This solution was not suitable for transparent holding systems as there was not necessarily any direct communication (and any contract) between account provider (CSD) and account holder, as the relationship was handled by an account operator instead.

Out of those stakeholders who provided a response, most didn't go into its second part, i.e. did not indicate whether it was reasonable to hold the account provider responsible for the veracity of his information.

Only 2 contributors disagreed with the question without providing explanations and 11 respondents, mostly French intermediaries, "feared" that an account provider who provided erroneous information would be held responsible.

Meanwhile, 7 contributors proposed to hold the account provider responsible for the veracity of his information. Of these 7, 4 respondents opted at the same time

- either for the conclusiveness of the communication (against and for the benefit of the account holder and any third party who relied upon it)

- or for limiting the circumstances in which the communication could be disregarded to those where fraud could be established.

3.14.3.1 Question

Q29: The Hague Securities Convention (www.hcch.net/index_en.php?act=conventions.text&cid=72) provides for a global harmonised instrument regarding the conflict-of-law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed Principle 14 differ from the Convention as regards the basic legal mechanism for the identification of the applicable law. However, the scope of Principle 14 is the same than the scope of the Convention: property law, collateral, effectiveness, priority. Do you agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, please explain why.

3.14.3.2 Statistical Response

Yes	23
No	15
No answer	70

3.14.3.3 Synthesis

38 stakeholders provided responses. 15 respondents did not agree that Principle 14 would facilitate the resolution of conflicts with third country jurisdictions and most of them expressed the opinion that only the signing and ratification of the Hague Securities Convention could foster global compatibility.

23 stakeholders agreed with the premise in question 29. It was felt that although global uniformity of connecting factors would be the best solution, providing for a coherent EU conflicts-of-law regime would facilitate matters with third-country reference as well. This was not only due to the common features between the two instruments in terms of scope and terminology, but also because the EU conflicts-of-laws regime would be known and would become predictable for the rest of the world.

3.15 Principle 15

15 – Cross-border recognition of rights attached to securities

1) *The national law governing a securities issue as well as the national law governing the holding of securities should not discriminate against the exercise of rights attached to securities held in another jurisdiction on the sole grounds that the relevant securities are held in a specific manner, in particular*

- *through one or more account providers,*
- *through an account provider acting in its own name but for the account of its account holders,*
- *through accounts in which securities of two or more account holders are held in an indistinguishable manner.*

2) *The national law should remain free to prescribe which holding methods account providers should offer to their account holders.*

3.15.1.1 Question

Q30: Would a general non-discrimination rule along the lines set out above be useful? Have you encountered problems regarding the cross-border exercise of rights attached to securities?

3.15.1.2 Statistical Response

Yes	47
No	15
No answer	46

3.15.1.3 Synthesis

62 contributors provided a response. 47 stakeholders supported the introduction of a non-discrimination rule along the lines of Principle 15 subject to some specific remarks.

A basic concern voiced by some Member States was that Principle 15 might require the amendment of their company law:

- The UK supported the ultimate account holder being able to exercise rights flowing from his securities, where he, the legal owner and the issuer agreed. The UK insisted that the ultimate account holder only had the rights the registered legal owner had agreed to give and hold for him, e.g. by way of a trust agreement. Such an agreement might also state that voting was exercised by a third party.
- German authorities requested clarification that the rule prescribed only recognition of nominee holding structures, but not recognition of the exercise of rights by nominees. German stock corporation law permits companies to set out in their articles that certain nominees (known as "proxy shareholders" – "Legitimationsaktionäre") may not be entered in the share register. If this applied, an account provider would be prevented from exercising shareholder rights "*in its own name but for the account of its account holders*". German issuers and investors proposed to solve this issue by adopting the last part of Article 29.2 Geneva Securities Convention ("*this Convention does not determine the conditions under which such a person is authorised to exercise such rights*").
- NL wondered whether it was necessary to extend the scope of this principle to other securities than shares, in particular to bonds.
- It was pointed out several times that paragraph 2 should not be allowed to thwart the effect of the first part of the non-discrimination rule - in particular that it should be not read as allowing the issuer's Member State to forbid holding through a nominee (Computershare).
- Paragraph 2 also concerned some intermediaries that it appeared to allow Member States' laws to require a national CSD to only offer the possibility of single beneficiary accounts to their account holders.

This would constitute a major obstacle to cross-border holdings as it would require all account holders in the chain to segregate securities positions in their books by ultimate account holder which could generate an insurmountable barrier for cross-border retail investors who would wish to invest directly in securities deposited at that CSD (AGC).

- The Commission was invited to explain how Principle 15 would operate in the future securities landscape expected to be created by the Target2 Securities platform (Pinsent).
- It was pointed out that the specific situation of “securities already in issue” should be contemplated. If Principle 15 resulted in overriding the terms of issue, it could be regarded as contravening the principle of non-retrospectivity, particularly if it had cost implications (CLLS-FLC).
- One respondent suggested that a more harmonised type of holding pattern should be advocated in the EU (Helex).
- Euroclear asserted that Principle 15 should go further and provide for a positive obligation for Member States to remove rules which pose obstacles to setting up cross-border links, or the exercise of rights on a cross-border basis, or which hamper the investor's choice of holdings.

15 respondents preferred not to see a non-discrimination rule in the envisaged legislation because they either doubted the practical use of a Principle at this high level of generality (AT, Swedish intermediaries, Spanish Infrastructure provider) or they insisted that there was cross-border holdings of collective custody services were not at a disadvantage (Equiniti, ICSA), while some at the same time said that shareholders’ meetings of companies domiciled abroad were “the sole exception” (German, French and European intermediaries).

However, 12 stakeholders confirmed that they had encountered problems in terms of cross-border exercise of rights and reported discrimination:

- in the context of participation in general meetings (detailed analysis by AFME and ZKA, however the latter was opposed to Principle 15),
- in Madoff related cases where holders of beneficial or economic interests had encountered difficulties having their position recognised to act in that capacity (through denial of standing in court or otherwise) and in Lehman related matters (attempts to disentangle the web of various interests had contributed to delays in distribution and allocation of rights),

- where the absence of any ability to appoint multiple proxies or to exercise votes in different ways constituted a practical obstacle,
- where the national law did not recognise the concept of a “nominee” (i.e. where shares are held in the account provider’s name on behalf of others),
- resulting out of national rules blocking the use of multi-tiered holding structures or nominee/omnibus accounts, which posed obstacles to setting up of cross-border links or the exercise of rights on a cross-border basis or which hampered the investor’s choice of holding patterns for his securities.

3.15.2.1 Question

Q31: If applicable, would a Principle along these lines have (positive or negative) repercussions on your business model? Please specify.

3.15.2.2 Statistical Response

Positive impact	12
Negative impact	8
No answer	88

3.15.2.3 Synthesis

20 contributors anticipated an impact on their business models. A positive impact was expected by 12 respondents (Austrian, German and Romanian Infrastructure providers, European and French intermediaries, issuers and investors).

One Infrastructure provider pointed out that Principle 15 would make its operations less time consuming and therefore less costly. Some intermediaries acknowledged that despite higher costs, the overall consequences would be positive, while one added that the Principle would represent an important step towards creating a single integrated European securities market.

However, 8 respondents (all intermediaries) anticipated a negative impact on their business models resulting from increased expenditure on the expansion of technological infrastructure and liability risks.

Due to a lack of harmonised rules on general meetings within the EU, the implementation of Principle 15 would require a huge amount of capacity from skilled employees. Specifically, it was feared that intermediaries would not receive information directly from the issuer CSD and would find themselves forced to contact every non-listed and non-dematerialised security issuer (e.g. according to ZKA, the German service provider “Wertpapier-Mitteilungen” which *inter alia* handled the distribution of information on foreign stock corporations currently had the necessary data for only 5 % of these companies).

In particular, Helex asserted that such a principle would create serious negative repercussions to the business model of transparent, direct holding systems by:

- increasing tax avoidance and the associated cost of monitoring tax avoidance (especially in cases of confidentiality clauses for client accounts kept with account providers in jurisdictions other than the one of the CSD),
- negatively affecting the transparent operation of the market and introducing high cost in terms of system, people and procedures to check and prove market abuse behaviour from clients situated in different jurisdictions,
- decreasing the frequency and quality of information that issuers are able to receive regarding their shareholders, at the same time as increasing the cost of performing such inquiries,
- increasing the cost for the CSD as it had to maintain two different types of operating procedures for all services (for the ultimate end investors' accounts with the CSD and those which belong to other account providers).

3.16 Principle 16

16 – Passing on information

- 1) *The national law should require that Information with respect to securities received by an account holder, which is not the ultimate account holder, from its account provider or from the issuer should be passed on to its account holder or, if possible, to the ultimate account holder without undue delay as far as information*
 - (a) *is necessary in order to exercise a right attached to the securities which exists against the issuer; and*

(b) *is directed to all legal holders of securities of that description.*

2) *The account provider of the ultimate account holder must pass on information with respect to the exercise of rights attached to securities received from the ultimate account holder to the issuer of the securities or, if applicable, the following account provider without undue delay, as far as information is provided by the ultimate account holder in the course of the exercise of a right attached to the securities.*

3.16.1.1 Question

Q32: Is the duty to pass on information adequately kept to the necessary minimum? Is it sufficient? If applicable, would there be any (positive or negative) repercussion of such a Principle on your business model? Please specify.

3.16.1.2 Synthesis

75 stakeholders provided responses. One contributor disagreed that the duty to pass on information was kept to the necessary minimum because Principle 16 could result in undesirable "petrification" whilst technology advanced and methods of communication other than processing information through the holding chain could work better and be more cost-effective in the future.

Several suggestions to limit the scope of the duty were made:

- Some issuers and investors actively supported the view that the duty to pass on information should not be made subject to a possible contractual opt-out. However, nearly half of the intermediaries (14) were of the opinion that an "opt-out option" (at least for voting rights) should be possible (at least) on an individual contract basis in order to leave the account holder the choice as to relevant information ("*a French retail account holder is highly unlikely to travel to participate in a Finnish AGM*").

Furthermore, some respondents expressly asked for an "opt-in solution", i.e. opposed any duty to automatically pass on information to all ultimate holders. They referred to the existing UK Companies Act 2006 under which ultimate account holders may request their account provider to facilitate the sending of information directly from the issuer to the ultimate account holder and noted that

the level of interest from ultimate account holders in receiving such information had been extremely low (less than 1 % of registered shareholders).

- Several respondents insisted that the duty to pass on information should be restricted if the measures to be taken by the account provider were economically unacceptable because the costs incurred were disproportionate to the possible claims of the account holder or if they were impossible to achieve in a manner timely enough to permit the ultimate account holder to actually make use of the information in exercising his rights. In this context the proposal was made to replace the wording "*if possible*" with "*if practicable*".
- Some German and European intermediaries found that Principle 16.2 was not efficient in every case. In many instances the schedule would not allow for passing information through the intermediary chain and back because the deadlines for preparation and execution of the shareholders' meeting were usually very short. In Germany the practice has evolved not to pass back the information that the ultimate account holder wished to participate in the shareholders' meeting, but to forward it directly to the issuer. The following drafting proposal was made: "*Where the addressee of the information could be reached without passing on the information upstream and downstream the account provider could do so*".
- Broadening of the scope was also proposed. There was widespread concern that Principle 16 would only apply to the "*account provider of the ultimate account holder*". This would mean that the other account providers in the chain were not under obligation to facilitate the ultimate account holder's rights. Three UK respondents proposed redrafting in this regard (UK authorities, Equiniti, ICSA). Moreover, some stakeholders asked to clarify that Principle 16 applied not just to account providers but also their third-party agents (as several custodian banks had outsourced proxy voting services to electronic voting agents).

Most contributors did not regard the rule as being *sufficient* for various reasons:

- French respondents considered the obligation as being too general. Some German, Luxembourgish and European intermediaries observed that the envisaged legislation should not make the issuer's primary obligation towards his shareholders obsolete. Imposing obligations (and also costs) on the intermediary

alone would provide no incentive for the issuer to deliver the information in a brief, standardised, electronic form and in English.

- More guidance was felt necessary on the term "*information*". It was asked whether "*information*" also included voting instructions and some third party information (e.g. information in relation to a takeover offer launched by a third party for the issuer necessary for the exercise of any "rights" attached to the securities if acceptance or approval of the offer did not involve a vote of shareholders of the issuer). It was suggested to clarify that the obligation of Principle 16.1 did not apply to publicly available information, e.g. quarterly reports.
- A suggestion was made that in line with keeping the information duty to the necessary minimum; the envisaged legislation should make the issuer responsible for the length and the content of the "necessary information." It was often impossible for the intermediaries, especially in a cross-border context, to assess which part of a long document was necessary to forward and which part of the document only contained ancillary information (examples provided by UniCredit).
- Clarification was sought as regards the passing on information "*without undue delay*". Some intermediaries proposed to allow the account provider to refrain from notifying the account holder if the information was not received by the account provider in a timely manner. Others observed that this principle might place unnecessary burdens on securities lending agents in respect of securities collateral they hold for their clients (it was customary for securities that were subject to corporate actions and dividends to be substituted over record dates).
- Concerns were voiced that there was no rule on who would bear the costs. Some felt that the intended "market solution" would no doubt mean that in the end the ultimate account holder would be asked to pay the costs by its account provider. Several respondents asked that envisaged legislation provide that the costs generated by any legal obligation to pass on information were born by issuers as part of their duties (originator of the information). However, issuers felt that it would appear unfair if this burden fell on them. The opinion was also voiced that passing on information was a service to account holders (beneficiaries of information) for which account providers should be fairly paid.
- Heavy repercussions on the business model were widely expected. Some guidance on costs involved was given by reference to German law on the

compensation of reimbursement of credit institutions which specifies the respective sums (reproduced by UniCredit).

The following specific remarks as regards the drafting of Principle 16 were made:

- It was pointed out that the wording “*the exercise of a right attached to the securities,*” could be read as referring to rights comprised in the securities e.g. the right to vote, and not as addressing the question of the rights over the security, i.e. the rights of property, e.g. the sale and pledge etc. As a result, information in the context of a takeover bid, i.e. an offer to purchase the securities, would appear to fall outside of the scope of the directive.
- Consideration needed to be given to potential conflict with restrictions on the passing on of information into certain jurisdictions or to classes of account holder, e.g. under securities laws (CLLS-CLC).
- It should be checked to what extent the envisaged legislation was aligned with the Transparency Directive 2004/109/EC (FI) and the Prospectus Directive 2003/71/EC (EBF).
- The absence of geographical limitation of the envisaged legislation would require the proposed flow of information to include cases where the issuer, the account provider, and the ultimate investor might be outside the EU. There may be a significant risk of violation of foreign law in such cases.
- The extent and basis of liability of an account provider if it failed to comply with its obligation to pass on information should be allocated. The principle does not specify which system of national law applies. As a result the account provider may be subject to the laws of several Member States, with differing standards, in complying with the principle.

3.16.2.1 Question

Q33: How do you see the role of market-led standardisation regarding the passing on of information? What are your views on a regulatory mechanism for streamlining standardisation procedures?

3.16.2.2 Synthesis

All contributors saw the potential benefits of a **market-led standardisation** on the passing on of information, but most of them supported it only on an optional basis. Almost all respondents pointed out to the Market Standards on Corporate Actions and the Market Standards on General Meetings which were agreed in September 2010.

Views differed considerably whether the envisaged legislation should provide for a **regulatory mechanism for streamlining standardisation procedures** (*"Referring to the existing Market Standards as the applicable and practical implementation rules of the Principles defined in the future directive would thus be very helpful for their implementation in the different markets"*) or not (*"These information flows will need to adopt over time and therefore should be not hard-coded into EU legislation"*). Some stakeholders encouraged the Commission to conduct a comprehensive impact assessment as *"this has the potential to be very expensive and of no real benefit"*. One Member State stressed that future regulation in this area, especially when it affects company law, should be enacted only on level 1 and not as provisions regarding technical implementation.

The ECB remarked that the new European Securities Markets Authority should foster such standardisation; the Eurosystem would also be in a position to co-operate in this regard, as it is currently involved in various groups fostering standardisation in various fields of corporate actions as part of the development of T2S.

3.17 Principle 17

17 – Facilitation of the ultimate account holder's position

- 1) *The national law should require that the account provider of the ultimate account holder should be bound to facilitate the determination of the exercise of rights attached to securities by the ultimate account holder against the issuer or a third party as requested by the ultimate account holder.*
- 2) *Such facilitation must at least consist in the account provider of the ultimate account holder*
 - (a) *arranging for the ultimate account holder or a third person nominated by the ultimate account holder being the representative of the legal holder with respect to*

the exercise of the relevant rights, if the account provider or a third person is the legal holder of securities, in which case Article 11 of the Shareholders' Rights Directive applies correspondingly; or,

(b) exercising the rights attached to the securities upon authorisation and instruction and for the benefit of the ultimate account holder, if the account provider or a third person is the legal holder of the securities; or,

(c) providing the ultimate account holder, regardless of whether it is the legal holder of the securities or not, with evidence confirming its holdings and it being enabled to exercise the rights attached to the securities against the issuer or a third party, under a general framework guaranteeing the integrity of the number of available rights and the position of the legal holder of the securities in respect of subparagraph (c) of paragraph 2. The content and form of the evidence to be provided should be specified and standard forms should be developed, in particular to define under which conditions issuers should recognise such evidence for purposes of exercising rights attached to securities.

3) The extent to which the obligations following paragraphs 1 and 2 can be made subject to a contractual agreement between the ultimate account holder and its account provider as well as the formal requirements to be met by such agreement should be subject to restrictions for purposes of client protection.

3.17.1.1 Question

Q34: If you are an investor, do you think that a Principle along the lines described would make easier any cross-border exercise of rights attached to securities, provided that technical standardisation progresses simultaneously? If not, please explain why.

3.17.1.2 Statistical Response

Yes	23
Yes or qualified yes	15
No or qualified no	11
No answer	59

3.17.1.3 Synthesis

The 49 stakeholders who responded to this question included non-investors to whom question 34 was not directly addressed.

11 respondents did not think that Principle 17 would make the cross-border exercise of rights any easier. They believed that it mandated a result that was impossible to achieve without harmonising Member States' company laws. A European Infrastructure provider even predicted that this Principle might result in forcing account providers to withdraw from providing cross-border services.

However, 23 contributors, mostly issuers and investors, insurers, asset managers and pension funds, supported Principle 17 as it stands. 15 stakeholders accepted the solutions envisaged by subparagraph (a) and subparagraph (b) but opposed subparagraph (c).

With regard to **Principle 17.1**, many respondents observed that it was not possible for the last account provider alone to facilitate the rights of the ultimate account holder. As the Netherlands authorities illustrated: "*In the situation where there is a cross-border holding chain, the chain is no stronger than its weakest link (i.e. when currently one account provider does not cooperate, the holding chain will no longer function)*".

This model was regarded as being vulnerable to failure, because investors had to rely on the contractual power of individual account providers to achieve an effective system for the exercise of shareholders' rights through a holding chain. Proposals were made to provide that each account provider in the chain had the obligation to facilitate the exercise of rights by the ultimate account holder.

Furthermore, the Swedish authorities recalled that the responsibility lay ultimately with the issuer and accordingly submitted a drafting suggestion to amend Principle 17.1. In this context Euroclear remarked that in many instances issuers would be incorporated outside the EU and thus beyond the reach of its legal regime.

As regards **Principle 17.2 (a) and (b)** a few contributors doubted whether it would always be possible for the account provider to fulfil its obligations set out in this principle. If the "*account provider of the ultimate account holder*" was also the "*legal holder*", no problems arose. However, if a third person was the legal holder, this third

party might refuse to give a proxy or to follow the instructions of the ultimate account holder.

Controversy was raised by **Principle 17.2 (c)** under which the "*account provider of the ultimate account holder*" was required to provide "*evidence*" of the holdings of the ultimate account holder to enable him to exercise the rights attached to the securities "*against the issuer or a third party*". This was regarded by most stakeholders as being contrary to Principle 1.2 which stated that the envisaged legislation should not harmonise the legal framework governing the question of whom an issuer had to recognise as the legal holder of its securities.

As regards the practical operation of Principle 17.2 (c), a substantial over-voting risk was predicted because the issuer would be obliged to accept every instruction received in the appropriate format from anyone nominated by an account provider, regardless of their legal position.

Some stakeholders pointed out that Principle 17.2 (c) had similarities to the discredited US system, notably the right of 'street name' investors, which were analogous to the ultimate account holder, to exercise their rights on a direct basis. They warned the Commission against replicating a model which was seriously questioned in its local market (as a recent consultation of the SEC revealed).

On the contrary, 13 German issuers and investors endorsed that without such certificates the exercise of rights might often not be possible and thus affirmed that it was of tantamount importance to include such a provision in the envisaged legislation.

Meanwhile the UK's National Association of Pension Funds went further and called for "a more functional approach to the exercise of rights attached to securities. Such an approach should ensure that ultimate account holders can actively vote on and engage with invested companies, regardless of whether they are deemed to be the legal holder of the shares under the relevant national law."

Principle 17.3 was generally welcomed both by the advocates of contractual limitations to the duty to facilitate the exercise of rights by account providers and by the advocates of limiting the abilities to contractually opt-out. 2 stakeholders asked for further clarification in terms of scope of client protection and one respondent argued that paragraph 3 should also take into account the rules of a SSS.

3.17.2.1 Question

Q35: If you are an account provider, would you tend towards the opinion that your clients can exercise the rights attached to their cross-border holdings as efficiently as their domestic holdings? What would be the technical difficulties you would face in implementing mechanisms allowing for the fulfilment of the duties outlined above? What would be the cost involved?

3.17.2.2 Synthesis

8 respondents asserted that investors faced more difficulties in exercising rights in a cross-border context than in a domestic one.

The general feeling of 18 other contributors, mostly intermediaries, was that with the exception of shareholders' meetings the cross-border exercise of rights worked sufficiently well.

The following **technical difficulties** were expected in implementing Principle 17:

- An account provider might not necessarily know that he was in the position of "*account provider to the ultimate account holder*". For retail brokers it might be obvious that they occupied this position, but not for Euroclear UK & Ireland who held international securities for the benefit of its members in a number of CSDs but had no means of knowing whether those members held their interests in these securities on their own behalf or whether they were at the head of a long holding chain themselves. For reasons of legal or commercial confidentiality, account holders might be reluctant to divulge details of persons on whose behalf they held securities and the account provider would have no guarantee that any information given was in fact correct.
- Only at the level of the issuer CSD was there visibility of the total holding. The account provider of the ultimate account holder, who might be located several tiers down from issuer CSD in the holding structure, was thus in no position to issue evidence confirming the ultimate account holder's entitlement to exercise rights or to guarantee the integrity of available rights. Similarly, the CSD at the top of the holding chain had no visibility of what ownership or other rights were passed down the chain of holdings to the ultimate account holder.

As regards the **costs** involved no estimates were made, but a high cost impact was expected as no market standards existed and legal risks for account providers could

arise. A few respondents indicated that Principle 17 might force certain participants to exit the cross-border market.

The following supplementary and alternative solutions to Principle 17 were suggested:

- Obliging issuers to provide information on the shareholder's meeting in due time standardised in an ISO or SWIFT format and in a language that is commonly used in a cross-border context.

In this context Helex observed that the facilitation of the ultimate account holder's position was the strongest point of a transparent holding system. With the help of the ISO (15022/20022) standards and the CA standards that have been commonly agreed and are under implementation by CSDs and market participants it is fully feasible to transfer announcements, rights to exercise/participate, payments and confirmations from the account provider of the ultimate investor to the CSD and back. All information was accessible to the client via the simplest technology for natural persons (web access to his CSD account or SMS message) or screens/files/ISO messages for legal persons.

- As an alternative to passing on information through the intermediary chain, the issuer should be obliged to provide information on its website, to which the account provider could refer account holders (Article 5.4 of Shareholders Rights Directive 2007/36/EC).
- Technical methods could be used to establish direct contact between issuers and investors, e.g. providing end-investors access to vote directly on an issuer interface.
- Including in the envisaged legislation a principle which provided for the transfer of the shareholder's data from the intermediary to the issuer (agent) so that the end investor could be entered into the share register. This would allow the issuer to inform the end investor in time and the end investor to exercise its rights safely.
- National laws regarding the general meeting should be further harmonised.
- Harmonisation of national rules regarding the holding chain (between the banks as account providers, the depositories and the central depositories) in order to facilitate the exercise of rights in due time prior to general meeting.
- Harmonisation of statutory requirements under which central depositories issue certificates needed for the exercise of voting rights (currently in Hungary the

maiden name of the shareholder's mother must be indicated while in the UK it is the passport number).

- Developing market practice standards, such as the Market Standards for Corporate Actions Processing created by the CAJWG (Corporate Actions Joint Working Group) which were now implemented in each country by the so-called MIGs (Market Implementation Groups) coordinated by the EMIG (European Market Implementation Group).

3.18 Principle 18

18 – Non-discriminatory charges

The national law should ensure that charges levied by an account provider on its account holders for any service relating to the compliance with any of the duties established in Principles 16 and 17 in respect of cross-border holdings of securities should be the same as the charges levied by that account provider on its account holders in respect of comparable domestic holdings of securities.

3.18.1.1 Question

Q36: If you are account holder, have you encountered differing prices for the domestic and the cross-border exercise of rights attached to securities? If yes, please specify.

3.18.1.2 Synthesis

20 stakeholders confirmed that they had encountered different prices for cross-border exercise of rights. The following examples were provided:

- Specific fees were required for the registering of shares from France to Belgium (ECGS).
- A certification of holdings of a security (which is necessary to exercise the rights enshrined in the security) was more expensive if it involved a cross border aspect (German issuers and investors).
- The cross-border exercise of voting rights was much more expensive, normally more than ten times, sometimes even more than hundred times the cost for a

purely domestic voting rights exercise (German issuers and investors). According to ECGS and ESH voting charges could reach up to €150 per voting session. The request for a ballot (voting card) at a French general meeting in Germany might easily be charged with €100 by the deposit bank whereas the request for a ballot at a German general meeting would still be free of charge for the securities holder.

- According to a survey by ICGN, 27% respondents indicated that they do take cost of voting into account in making the decision to vote at a shareholder meeting.

3.18.2.1 Question

Q37: If you are an account provider: do you price cross-border exercise of rights differently from domestic exercise? If yes: on what grounds are different pricing models necessary?

3.18.2.2 Synthesis

9 stakeholders declared that they do not price differently.

2 associations of intermediaries explained that their members applied different pricing models. Some account providers did not differentiate between countries when pricing services offered in connection with capital measures. Other differentiated their pricing model based on the deposit types which produced different costs.

One respondent explained that in reality charges were a contractual matter and frequently formed part of a bundled rate (where other services were offered simultaneously). A bank could be connected either directly or indirectly to securities markets globally. In case other intermediaries were involved, any account provider would have to pass on these third party costs which were an important driver of different cost arrangements. It was evident that the longer the intermediary chain, the higher the costs for the account provider, and securities issued in a country other than that of the relevant account provider were more likely to go through a larger number of levels of intermediation.

11 stakeholders confirmed that they differentiated their pricing models because costs in the cross-border context were increased by some of the following factors:

- Different complexity in processing rights attached to securities,
- Different costs charged by foreign account providers,
- Additional costs through different currencies,
- Different tax status of account holders/providers (*"Even with a simple dividend payment, foreign account providers need to take into consideration double taxation agreements, relief at source or tax reclaim procedures, etc"*).
- Differences of language,
- Communication through a longer chain of intermediaries,
- Extra work due to a different legislation regarding book-entry system,
- Foreign law applicable to the security issued abroad (*"It often implies complex legal descriptions and requirements which have to be understood in the context of local jurisdictions and specific processes based on national laws and regulations or individual company requirements that are governing such type of transactions"*),
- Additional costs for ordering admission tickets to shareholders' meetings (€45 to €100 per depository for a foreign shareholders' meeting),
- Margin for higher legal risk involved in cross-border operations.

From the perspective of an Infrastructure provider the reasons for higher costs of service were divided into 3 broad categories:

1. costs of establishing links with cross-border CSDs and other providers;
2. costs of maintaining those links, and;
3. day-to-day operational costs (see further detailed analysis by Euroclear).

As regards Principle 18, the following comments were made:

4 respondents (ECGS, ESH, ABI-Euromedion-Eurosif, ICGN) supported Principle 18 because account providers' services relating to passing on voting instructions should be available at an affordable price so that the level of fees must not be a barrier to vote. However, 3 of them found that Principle 18 was not sufficient enough and some additional safeguards were needed, e.g.:

1. The European Securities Markets Authority (ESMA) could be given powers to monitor and, when appropriate, ensure transparency and competition in pricing to ensure an effective and user friendly voting chain;
2. Allocation of costs from the account provider to the issuers (as the proposal would result in a higher ultimate account holder participation in the shareholders' meetings, the issuer and all its shareholders and other stakeholders would benefit).

One institutional investor (Af2i) responded that it had no problem with Principle 18 as long as the extra costs of cross-border investments were not spread on the charges of the national investments. Three others (EuropeanIssuers, Equiniti, ICOSA) supported the view that cross-border shareholders should not be discriminated against by their account providers, but found that it was not appropriate to subsidise cross-border holders by domestic holders - which would be the inevitable effect if the issuer were obliged to meet the costs of facilitating the exercise of their rights.

Altogether, 22 intermediaries, 7 Infrastructure providers, 4 issuers & investors and 4 other stakeholders opposed Principle 18 based on the following arguments:

- From the perspective of an account holder it could not be regarded as discriminatory to charge such additional services entailing very high extra costs, merely to the small number of account holders (less than 1% of account holders with foreign shares in the securities account), who generate these costs.
- It was not realistic to expect an account provider to incur the same cost in facilitating entitlements in its domestic market as in foreign markets.
- The likely result of such a requirement would be for some account providers to restrict their offering to their domestic market and/or raise the price of their domestic service to bring them in line with those of their services on foreign markets. Either way, the outcome was not in line with an integrated European market.
- Correlation between prices and cost of the service offered would be removed because of the need for cross-subsidisation. This would introduce an element of artificiality into existing pricing tariffs. Such a result not only defeated the purpose of market efficiency and investor protection, but was also inconsistent with the EU

objective to prevent the distortion of effective competition between national markets.

- The reference to the approach used in the payment area was misleading and unjust. The complexity of the processing of cross border exercise of rights was far greater than the processing of payment instructions. The exercise of rights attached to securities was often subject to complex legal terms and conditions that had to be understood in the context of local requirements and specific processes based on domestic laws and regulations or requirements of the issuer. Many cross border rights exercises involved more work and therefore higher costs. Principle 18 was not workable as long as regulations and process requirements were not harmonised at European level.
- The impact of Principle 18 (preventing account holders from recovering compensation through objectively justifiable charges for the costs and risk of providing services for securities held in a foreign CSD) in combination with Principle 1 (increasing regulatory burdens and associated costs by submitting all account providers to MiFID) could cause unforeseen systemic risk in the financial markets. A legislative measure in this regard should be subject to an impact assessment.
- As regards the wording of Principle 18, clarification was sought on the meaning of 'comparable' domestic holdings, which might lead to practical difficulties in determining the scope of this provision, and on 'cross-border holdings of securities', i.e. whether it meant holding of non-domestic securities issued in another EU member state or securities issued in any jurisdiction other than jurisdiction of the account provider.

Some of those who opposed Principle 18 stressed that they supported the objective and transparent pricing of account holding services. For example, it was considered that some averaging could be allowed in order to ensure that tariffs were clear to customers.

3.19 Principle 19

19 – Holding in and through third countries

An account provider should make reasonable and appropriate arrangements with its account holder if the account holder maintains account-held securities for others and is not subject to the rules of this Directive, facilitating the effective exercise of rights attached to the securities which the account holder holds for others. Technical standards to be adopted by the Commission on this issue could be envisaged.

3.19.1.1 Question

Q38: Have you encountered difficulties in using non-EU linkages as regards the exercise of rights attached to securities? If yes, please specify. If not, please explain why.

3.19.1.2 Statistical Response

Yes	31
No	4
No answer	73

3.19.1.3 Synthesis

35 stakeholders responded to this question.

4 respondents, mainly German intermediaries, encountered no difficulties in using non-EU linkages as regards the exercise of rights other than participation in shareholders' meetings (e.g. capital increase, squeeze-out). This was due to the fact that the passing on of information or the exercise of rights was based on international standardised communication channels (SWIFT). This was different only for shareholders' meetings where specific national company laws applied.

One respondent pointed out that the difficulties were much the same as with EU linkages (e.g. incompatible laws, need to do due diligence), or might actually be less acute; e.g. for EUI linking with a CSD in another common law jurisdiction might in theory be easier than linking with a CSD in an EU jurisdiction.

31 stakeholders confirmed that they had experienced practical difficulties and provided the following examples:

- The difficulties encountered in certain jurisdictions related to operational aspects, extra costs, delays, non-assumption of obligations to allow the exercise of rights flowing from the securities.
- The securities, e.g. in Swiss listed companies, were deposited in omnibus accounts which made it difficult for account holders to receive a proof of their securities holdings which was needed for exercising rights attached to securities, i.e. voting rights.
- Non-recognition of the "nominee concept" in some foreign jurisdictions.
- Difficulties with receiving information in time from the issuer or the CSDs, albeit proper agreements were in place.
- There was very long cut-off delay needed by big proxy voting stations for voting shares internationally.
- The insolvency of Lehman Brothers evidenced the difficulties in enforcing investors' rights against the creditors of a non-EU account provider.

The following points were raised on Principle 19

Views differed considerably on the issue of whether there was really a need for Principle 19 to promote the envisaged legislation through the holding chain outside the EU. The German Association of Foreign Banks observed that all third country intermediaries providing services to European investors had branches or subsidiaries in the EU.

Against this background several German issuers and investors claimed that Principle 19 should be made mandatory for all intermediaries offering services with a link to the EU and in case of non-compliance effective sanctions should be considered.

However, some UK respondents questioned on what legitimate basis European institutions should seek to impose (in effect) extra-territorial reach on their legislative measures – especially where the underlying clients had voluntarily elected to contract with and use the services of a non-EU account provider.

Moreover, concern was voiced that EU account providers would not be able to meet any obligations to ensure certain behaviour by account holders outside the EU vis-à-vis their own account holders because these account holders would be subject to their own, wholly different legal regimes which might conflict with the envisaged legislation.

This would result in a source of disrepute for EU laws – as the "obligations" contained in Principle 19 would be more respected in their breach, rather than their compliance. Concern was voiced that this might undermine market confidence in European financial markets.

It was pointed out that EU account providers could face competitive disadvantages vis-à-vis non-EU account providers. An affected EU account provider, e.g. a German custodian bank, would always also have to "sell" the set of obligations contained in the future EU directive during contractual negotiations with an account provider from a third country, e.g. an account provider from Switzerland. A competitor from a third country, e.g. an account provider from the United States, in negotiations with the same account provider (in Switzerland) would not have to do so.

The terms 'reasonable' and 'appropriate' gave little explanation as to the requirements imposed on EU-based account providers. It was claimed that the account provider had only the ability to select its contractual partner to the best of its knowledge following a careful examination.

The provision deserved further clarification as to the applicable law under which the account provider would become liable when he had made all reasonable and appropriate arrangements with its foreign account holder, who subsequently failed to fulfil the principles outlined in the envisaged legislation.

Principle 19 could also place an onerous obligation on EU account providers to compensate for any errors committed outside the EU. This would effectively require EU-intermediaries to underwrite third country investment risk.

3.19.2.1 Question

Q39: Admitting that non-EU account providers cannot be reached by the planned legislation, which steps could be undertaken on the side of EU account providers involved in the holding in order to improve the exercise of

rights attached to securities through a holding chain involving non-EU account providers?

3.19.2.2 Synthesis

The following steps were identified that could improve the exercise of rights attached to securities through a holding chain involving non-EU account providers:

- EU account providers could be committed to include in their contractual agreements with non-EU account providers provisions mirroring the content of EU legislation.
- Promoting EU accepted market standards, i.e. Market Standards for Corporate Actions and for General Meetings. Non-EU account providers applying those standards should be treated like EU countries and considered as compliant with those Standards without any further requirements.
- Recourse to best practices which were generally consistent with legal regimes outside of the EEA currently undertaken by Association of Global Custodians ("Proposed Approach for Selection, Supervision and Oversight of Foreign Sub-Custodians and Settlement Systems" - appendix 2 of AGC contribution).
- Pursuing transparency (account providers informing their account holders of the custody structure and any related constraints).
- The adoption of the Geneva Securities Convention would be the quickest way to make progress towards a more standardised global regime for intermediated securities.
- Negotiations with third country authorities on possible mutual recognition (the new European Supervisory Authorities could help as negotiating parties).

3.20 Principle 20

20 – Exercise by account provider on the basis of contract

Where an ultimate account holder is able to exercise itself the rights flowing from securities but does not want to do so, its account provider exercises these rights upon its authorisation and instruction and in accordance with the contractually agreed level of services. There should be an EU-wide standard regarding the formal

requirements to be met by such an agreement as far as it provides for general authorisation of the account provider to exercise the rights flowing from the securities.

3.20.1 Question

Q40: Do you think that a general authorisation to exercise and receive rights given by the account holder to the account provider should be made subject to certain formal requirements? Please specify.

3.20.2 Statistical Response

Yes	14
Yes or qualified yes	3
No or qualified no	35
No answer	56

3.20.3 Synthesis

52 contributors responded to this question. 14 contributors supported the Principle as it stands and 3 supported it conditionally. They pointed out that the automatic exercise of rights by the account provider could undermine corporate governance (ICGN, Euromedion, BME, Computershare, DFSA) and deprive the account holder of exercise of its ownership rights (AFG, SGSS, AFTI).

This group of respondents argued that general and permanent authorisation on a contractual basis to exercise shareholders' rights should be discouraged. Consequently, they believed that exercise of rights by the account provider should be made subject to formal requirements.

Some contributors reflected on the merit of such requirements and observed that such authorisation should be given explicitly, in writing and be revocable. Section 135 of the German Stock Corporation Act ("Aktiengesetz") was pointed at as an example.

However, 35 stakeholders, mostly intermediaries, did not see any consistent reason to regulate formal requirements and provided the following arguments:

- Parties should be free to determine between themselves contractual formalities and service standards. Some categories of investor were not interested in exercising the rights attached to securities and they should be free to agree levels of service that reflected this.

If there was clear evidence that account holders were being pressured to agree to levels of service that they were not happy with, this should be tackled by legislation in the area of contract law or consumer rights, rather than by setting out a blanket restriction on the service levels account providers might agree to provide.

- Article 11 of the Shareholders' Rights Directive already contains rules on proxy voting, responsibilities of account holder's representatives and sets certain formal requirements. There was no further need to specify formal requirements and this should be left to the applicable corporate law.
- This was a matter for national law relating to the exercise of property rights.
- EU-wide legislation on formal requirements governing the general authorisation to exercise and receive rights provided by the account provider distorted existing market practice and stifled competition.
- The trend in EU law generally had been to treat formalities as a potential barrier to trade and to circumscribe their application, e.g. the Financial Collateral Directive limited formalities required in national law for the recognition and enforcement of the rights of a collateral taker. A collateral taker might well be an account holder in relation to the collateral.
- Finally, 3 respondents observed that account providers should have the right, but not the obligation to represent the account holders in the exercise of their rights (*"if, for example, a client holds one share in a stock corporation in Spain, it would be disproportional to oblige the German bank to exercise the rights of this one shareholder in the general meeting in Spain (either itself or through a chain of intermediaries)"*).

3.21 Principle 21

21 – Account provider status

All securities account providers should be regulated on a European level. To this end, 'safekeeping of securities [etc.]', Annex I Section B (1) of the MiFID, should be upgraded to become an investment service (under Section A(9) of Annex I) and those which provide this service should be authorised and supervised under MiFID.

3.21.1 Questions

Q41: Should the status of account provider be subject to a specific authorisation? If not, please explain why.

Q42: If yes, do you think that MIFID would be an appropriate instrument to cover the authorisation and supervision of account providers?

3.21.2 Statistical Response

Yes	27
Qualified yes	29
No	4
No answer	48

3.21.3 Synthesis

60 contributors provided answers. Only 4 respondents (German authorities, German, Dutch and European intermediaries) disagreed with question 41. They saw no reason for submitting account providers to special authorisation requirements because securities account business was usually banking business and as such subject to high prudential requirements. Harmonisation of supervisory conditions for security deposit business was risky because the level of protection currently guaranteed under German law might be lowered.

27 stakeholders agreed that only institutions that have been authorised by the relevant supervisory authority should be permitted to maintain securities accounts for their clients. The ECB stressed that account-held securities were heavily dependent

on the regime applying to account providers, and the EU should, in view of the integration of its securities market, ensure maximum compliance across-borders with the duties imposed on such service providers by the envisaged legislation.

The status of account providers currently varies in the different EU countries and mutual recognition should be accompanied by a harmonised regime, based on regulation and supervision, to permit and facilitate cross border provision of account provider services by enhancing legal certainty.

29 contributors agreed that it was desirable to have regulatory supervision, but they could not support Principle 21 as it stands. Some wanted to see specific groups of account providers excluded (e.g. issuers and their agents, CSDs), while others were not sure whether the envisaged legislation was the appropriate vehicle to impose regulatory conduct of business requirements on account providers or whether the supervisory framework applicable to all account providers should be the one established by MiFID.

The following views were expressed in response to question 42:

- The proposal to require account providers to obtain authorisation under Article 5 of MiFID was mostly accepted.
- However, concerns were raised about the proposal to convert account provision from an "ancillary service" to a full MiFID "investment service" As a result, many provisions of MiFID, which were designed with broking services in mind, would apply to account-providers. These provisions, e.g. detailed documentation requirements and fuller "Know Your Customer" checks to assess 'appropriateness' of the service, were regarded as irrelevant to custody services, but they would add an additional cost burden on account providers.
- More specifically, some stakeholders feared that this expansion would lead to considerable and wide-ranging consequences, not only for the account-held securities business, but also for already licensed investment services companies. For example, the requirement for the independence of the compliance function would be expanded to include safekeeping. This could be disproportionate, in particular for smaller and medium-sized account providers, which currently handled safekeeping and compliance function by one department.

- European Infrastructure providers believed that CSDs should be addressed only by the upcoming CSD legislation and not by MiFID. Applying MiFID requirements to CSDs in addition would result in duplicated and overlapping requirements. If the envisaged legislation extended MiFID requirements to safekeeping and administration functions, CSDs should therefore be excluded.
- The Hungarian authorities observed that central banks were involved in safekeeping and administration of financial instruments, but they would be captured by Article 2.1(g) of the MiFID exemption and fall outside the definition of “account provider”. Furthermore, as a result of Article 4(1)1 MiFID safekeeping and administration of financial instruments in future could only be provided by investment firms or credit institutions which would prohibit, e.g. practices of solicitors acting as custodians (safekeeping financial instruments for their clients).

3.22 Principle 22

22 – Glossary

(a) *‘securities’ means financial instruments as listed in Annex I Section C of Directive 2004/39/EC, which are capable of being credited to a securities account;*

(b) *‘securities account’ means an account between an account provider and an account holder allowing for the evidencing of securities holdings of that account holder with that account provider;*

(c) *‘account provider’ means a person who:*

- *maintains securities accounts for account holders and is authorised in accordance with Article 5 of Directive 2004/39/EC to provide services listed in Annex I Section A indent (9) of Directive 2004/39/EC or is a Central Securities Depository as defined in [...] and, in either case, is acting in that capacity;*

- *[in relation to Principles 3 to 13, if not subject to a national law, in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;]*

(d) *‘account holder’ means a person for whom an account provider maintains a securities account, whether that person is acting for its own account or for others, including in the capacity of account provider;*

(e) *‘ultimate account holder’ means an account holder which is not acting in the*

capacity of account provider for another person;

(f) 'legal holder' means the shareholder, bondholder or holder of other financial instruments, as defined by the national law under which the relevant securities are constituted;

(g) 'insolvency proceeding' means any winding-up proceeding or reorganisation measure as defined in Article 2 (1)(j) and (k) of Directive 2002/47/EC;

(h) 'insolvency administrator' means any person or body appointed by the administrative or judicial authorities whose task is to administer an insolvency proceeding;

(i) 'securities of the same description' means securities issued by the same issuer and being of the same class of shares or stock; or in the case of securities other than shares or stock, being of the same currency and denomination and treated as forming part of the same issue;

(j) 'securities settlement system' means a system as defined in Article 2(a) of Directive 98/26/EC for the processing of transfer orders referred to under the second indent of Article 2(i) of Directive 98/26/EC;

(k) 'acquisition' means the receiving of account-held securities or of a security interest or other limited interest therein;

(l) 'disposition' means

- to relinquish account-held securities (disposal), in particular for the purpose of a sale,

- to create security interests or other limited interests in account-held securities in favour of another person, or

- to relinquish security interests or other limited interests in account-held securities.

(m) 'reversal' means that a crediting, debiting, earmarking or removal of an earmarking is undone by a converse act;

(n) 'crediting' means the adding of account-held securities to a securities account;

(o) 'debiting' means the subtracting of account-held securities from a securities account;

(p) 'earmarking' means an entry in a securities account made in favour of a

person, including the account provider, other than the account holder in relation to account-held securities, which, under the account agreement, a control agreement, the rules of a securities settlement system or the applicable law, has either or both of the following effects:

- that the account provider is not permitted to comply with any instructions given by the account holder in relation to the account-held securities as to which the entry is made without the consent of that person;

- that the relevant intermediary is obliged to comply with any instructions given by that person in relation to the account-held securities as to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement or the rules of a securities settlement system, without any further consent of the account holder;

(q) 'control agreement' means an agreement in relation to account-held securities between an account holder, the account provider and another person or, if so provided by the applicable law, between an account holder and the account provider or between an account holder and another person of which the account provider receives notice, which includes either or both of the following provisions:

- that the account provider is not permitted to comply with any instructions given by the account holder in relation to the account-held securities to which the agreement relates without the consent of that other person;

- that the account provider is obliged to comply with any instructions given by that other person in relation to the account-held securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the account holder;

(r) 'attachment of account-held securities of an account holder' means any judicial, administrative or other act or process to freeze, restrict or impound account-held securities of that account holder in order to enforce or satisfy a judgment, award or other judicial, arbitral, administrative or other decision or in order to ensure the availability of such account-held securities to enforce or satisfy any future judgement, award or decision.

3.22.1.1 Question

Q43: Do the terms used in this glossary facilitate the understanding of the further envisaged Principles? If no, please explain why.

3.22.1.2 Synthesis

Out of 108 responses, only one contributor did not find the glossary helpful. With regard to the detailed comments:

Paragraph (a) – “securities” was felt to be unclear and probably too wide (mostly UK respondents). The current definition covered all financial instruments under MiFID where they were “capable of being credited to a securities account”. Some respondents wondered whether this wording would cover, e.g. “on exchange traded derivatives” which were mostly “held” on a principal to principal basis through a chain of back to back contracts flowing from central counterparty, through clearing members, their clients and their clients.

Adopting a broad reading would extend the scope of the envisaged legislation from "securities" in the traditional sense to instruments such as derivatives, money market instruments and fund units. Given that such contracts involved liabilities as well as rights and their underlying subject matter would cover not only shares and bonds but also commodities and interest rates, certain principles of the envisaged legislation, such as the facilitation of rights and the cross-border recognition of securities, could not be applied to accounts holding the above instruments.

Several stakeholder insisted on greater clarity of drafting to ensure that UCITS were excluded, as this would extend the definition of "account providers" to “transfer agents” which might result into converting transfer agency functions into a different service similar to custody services being provided to unit-holders as the agent's clients.

The Commission was therefore asked not to introduce legal uncertainty and urged to limit the scope of the definition along the lines of Article 1(a) of the Geneva Securities Convention. The following drafting was proposed: “*‘Securities’ means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Directive*” (CLLS-FLC).

As regards **paragraph (b) – “securities account”**, the main point raised was that only “safekeeping accounts” should carry the legal effects specified in the envisaged legislation and mere “administrative records” should be clearly excluded (e.g. records of securities formerly held in custody but lent out by clients because they merely represented entitlements to have such securities returned at the end of the loan).

Some drafting amendments were proposed:

1. “*securities account means an account opened by an account provider for an account holder*”,
2. deletion of the words “*with that account provider*” at the end of the definition in order to reflect the UK reality that an entry in the securities account did not evidence holdings of the member “with” the operator of CREST (see detailed analysis by CLLS-FLC).

Paragraph (c) – “account provider” was commonly felt to be very wide and covering numerous entities having various roles, such as custodians, escrow agents, nominees UCITS, AIF depositaries and (potentially) company registrars.

It was pointed out that it was not clear in the CREST context which parties would be an “account provider” (EUI itself, a CREST member who held securities on behalf of clients, a CREST Sponsor, a CREST settlement bank providing liquidity to CREST participants or all of them).

Questions arose as regards UCITS funds (and other investment funds) which in some Member States were registered in the CSD in the same way as shares and other instruments. In such countries it was unclear whether the CSD would be considered as an account provider under the SLD. Besides, in cases when the fund was not registered with the CSD but was kept instead with a transfer agent, it was unclear which entity would be considered as the account provider.

Two drafting amendments of Paragraph (c) were proposed:

1. first indent should read: “*for account holders as well as for itself and is authorized*”;
2. addition of the following: “*‘account provider’ does not mean a person such as a central securities depository, central bank, transfer agent or registrar or issuer engaged in the functions of creation, recording or reconciliation of*

securities, or otherwise acting on behalf of the issuer of those securities.”
(EuropeanIssuers, Equiniti, ICSA)

Several contributors voiced their concerns against linking the definition of "account provider" to the existence of any authorisation from a supervisory authority. It was felt that irrespective of whether the account provider performed functions that were regulated, the protections afforded to account holders by the envisaged legislation should apply to all account providers.

The following drafting proposal was made: *”’account provider’ means a person who in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity”.*

Furthermore, a clear statement was requested that the status of a person as an account provider, and the rights of his account holders, would not be affected by the loss of any authorisation or other relevant regulatory status.

Norwegian authorities considered that Paragraph (c) might need further clarification in respect of an “account operator” in transparent holding systems.

It was observed several times that Paragraph (c) failed to specify a geographic scope of application which seemed to suggest that the envisaged legislation was capable of applying to securities held outside EU. This would lead to conceptually unworkable solutions in other parts of the text. As a result, 12 respondents suggested the deletion of the second part of the definition of “account provider”, which was currently in square brackets.

Paragraph (d) – “account holder” was considered by many respondents as being confusing because it included final investors as well as intermediaries. Some observed that the notion was redundant because the “account holder” was either “account provider” or “ultimate account holder”. More specifically, the question was posed as to whether a management company of investment funds, who was typically obliged to keep accounts of the unit holders, was an account holder.

As regards **paragraph (e) – “ultimate account holder”**, one respondent warned of a regulatory gap which could arise because it was not clear whether Principle 21 comprised all “account providers”.

As the term “account provider” was used to define the term “ultimate account holder”, it should be prevented that an account provider who only held securities in safekeeping for third-party account was allowed to exercise the rights arising out of the ownership of securities.

Several respondents wondered whether the “end investor” of the Market Standards for General Meetings and for Corporate Actions corresponded to the “ultimate account holder” and found that it would not always be the case.

Several respondents wanted to see **paragraph (f) – “legal holder”** aligned with the definition of “shareholder” under the Shareholders Rights Directive. Several other drafting proposals were made:

1. legal holder should mean only shareholder according to directive 2007/36/EC,
2. legal holder should mean the person who is recognised by the issuer of the securities as entitled to exercise, as against the issuer, the rights attached to the securities,
3. in the current definition the term “securities” instead of “financial instruments” should be used.

Finally, many stakeholders observed that “legal holder” would not always correspond to the “end investor” of the Market Standards for General Meetings and for Corporate Actions.

One respondent argued that the term defined in **paragraph (g) – “insolvency proceeding”** should be used in Principle 10.1 instead of “insolvency”. The ECB stressed that the definition should be a broad one and cover not only collective proceedings, including interim proceedings, aimed at liquidation of the account provider, but also reorganisation measures aimed to preserve or restore the financial situation of the account provider.

Paragraph (j) – “securities settlement system” led two stakeholders to note that there might be some overlap between this paragraph and the definition of “account provider” in paragraph (c) which included Central Securities Depository.

It was suggested to clarify the distinction between a SSS, which was a system to record the transfer of ownership of securities by debiting and crediting accounts, from depositories or custodians who hold securities on behalf of their customers (see analysis by UK Payments).

As regards **paragraph (k) – “acquisition”**, two respondents questioned whether this definition was really necessary.

Similarly, these two stakeholders did not regard **paragraph (l) – “disposition”** as being inevitable. One respondent felt it was counterintuitive that the definition of “disposition” included, beyond disposal, both creation and relinquishing of security interests or other limited interests, and suggested reserving the term “disposition” for disposal.

It was suggested that **Paragraph (n) – “crediting”** should be aligned with the solution adopted in the Geneva Securities Convention, i.e. not to define what constituted a credit. Alternatively, the following drafting proposal for paragraph (n) was made: *“as determined in accordance with the account agreement or the rules of a securities settlement system”* (CLLS-FLC).

The same adjustment was proposed for **paragraph (o) – “debiting”**.

Paragraph (p) – “earmarking” seemed to narrow to one respondent who suggested that the definition should expressly cover the situation where securities were transferred into an account charged or pledged in favour of a collateral-taker or held in its name or on its behalf.

Secondly, it was observed that the wording *“an entry in a securities account made in favour of a person”* suggested that the entry had to appear in the designation of the account and this raised doubts whether computer-based systems used by account providers across the EU were capable of designating accounts in the desired way.

Finally, many respondents pointed out that paragraph (p) second indent should read “account provider” instead of “intermediary”.

Several respondents asked for clarification about the scope of paragraph (p) – “earmarking” in relation to **paragraph (q) “control agreement”**, e.g. there was doubt whether “pledge” was included within the concept of the former or the latter.

The second indent appears to have generated confusion where "earmarking" refers to "control agreements" and it was questioned whether the intention was that the earmarking control agreement amounted to something akin to an English law fixed charge (i.e. the chargee has the control) whereas the non-earmarking control agreement amounted to something more akin to an English law floating charge (i.e. the chargor has the control).

3.22.2.1 Question

Q44: Would you add other definitions to this glossary?

3.22.2.2 Synthesis

It was suggested to add the following definitions:

- **“Account-held securities’** means securities held by an account holder in a securities account with an account provider”. (DACSI)
- **“End investor”**: as defined by Market Standards on Corporate Actions and on General Meetings. (EU-EACB, CA-cib, CA-Titres, CA-SA, EUROPLACE, BNPP, BP2S, CACEIS, FR-AFG, FR-SGSS, FR-AFTI)
- **“Maintains securities accounts’** means to maintain, keep and enter up securities accounts and any other act in connection with the making, alteration and deletion of entries on securities accounts where:
 - the account provider may or may not in addition perform safekeeping functions in relation to the securities credited to the securities accounts; and
 - the securities accounts are not being maintained by the account provider on behalf of an issuer of securities under arrangements made between the account provider and the issuer.” (CLLS-FLC, Euroclear, ISDA).

- **“Safekeeping functions’** means the safekeeping and administering of securities for the account of clients.” (CLLS-FLC, Euroclear, ISDA)
- **“Rules’ / ‘Rules of a securities settlement system’** means, in relation to an SSS, rules of the system (including system rules constituted by national law) which are common to the participants or to a class of participants and are publicly accessible.” (CLLS-FLC, Euroclear, ISDA)
- **“Issuer’s Corporate Action Information’** means information (a) necessary in order to exercise a right attached to the securities which exists against the issuer and (b) directed to all legal holders of securities of that description with respect to securities received by an account holder, which is not the ultimate account holder, from its account provider or from the issuer” (ECGS).
- **“Entitlement Corporate Action Information’** means information from the account provider of the ultimate holder with respect to the exercise of rights attached to securities received, directed to the issuer of the securities or, if applicable, the following account provider, as far as the information is provided by the ultimate account holder and including the account identification at his request” (ECGS).
- **“Detailed Corporate Action Instructions’** means information from the ultimate holder with respect to the exercise of rights attached to securities received, directed to the issuer of the securities or, if applicable, to the account provider the following account provider, as far as the information is provided by the ultimate account holder and including detailed corporate actions or voting instructions” (ECGS).
- The ECB suggested using as a reference material the **Glossary for terms related to payment, clearing and settlement published by the Eurosystem** on the ECB’s website.⁷

⁷ See http://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystems_en.pdf?b95b9b9872b785afca97d00d5995b4d4.

ANNEX: List of Respondents

Country	Infrastructure providers	Intermediaries	Issuers & Investors	Public authorities	Others	Total
Austria	- Oesterreichische Kontrollbank Aktiengesellschaft (OeKB)	- Wirtschaftskammer Österreich (WKO)		- Bundesministerium der Justiz (AT)	- P. Pöch (Pöch)	4
Belgium		- BNP Paribas Fortis (Fortis)		- Belgian authorities (BE)		2
Bulgaria	- Bulgarian Central Depository (CSD)					1
Czech Rep.						0
Cyprus						0
Denmark	- VP Securities A/S (VP)			- Danish Financial Supervisory Authority (DFSA)		2
Estonia	- Estonian CSD (NASDAQ OMX)					1
Finland		- Federation of Finnish Financial Services (FFI)		- Finnish Ministry of Justice (FI)		2
France		- Crédit Agricole Titres (CA Titres) - Crédit Agricole corporate and investment bank (CA-cib) - Crédit Agricole S.A. (CA-SA) - BNP Paribas Group (BNPP) - BNP Paribas Securities Services (BP2S) - CACEIS	- Af2i association (Af2i) - Mouvement des Entreprises de France (MEDEF) - Association Française des Marchés Financiers (AMAFI) - Association Française de la Gestion Financière (AFG) - L'Oréal	- French authorities (FR)	- D. Martin - T. Bonneau - H. Synvet - J-J. Daigre - Groupe Eurostock (Eurostock) - C. Saule - D. De Wit - Paris Europlace (Europlace) - French Association of Securities Professionals (AFTI)	23

		<ul style="list-style-type: none"> - Société Générale Securities Services (SGSS) - Fédération Bancaire Française (FBF) 				
Germany	<ul style="list-style-type: none"> - Clearstream Deutsche Börse Group (Clearstream) 	<ul style="list-style-type: none"> - Zentraler Kreditausschuss (ZKA) - Verband der Auslandsbanken (VAB) 	<ul style="list-style-type: none"> - ERGO Versicherungsgruppe (ERGO AG) - ERGO Lebensversicherung AG (ERGO Leben) - Forst Ebnath AG (Forst) - MR-Beteiligungen AG (MR) - ERGO Versicherung AG (ERGO Versicherung) - Münchener Rückversicherungsge-sellschaft (Munich Re) - MEAG Munich ERGO Asset/Management GmbH (MEAG) - Deutsche Lufthansa Aktiengesellschaft (DLH) - Deutsches Aktieninstitut, Bundesverband der Deutschen Industrie, Gesamtverband der Deutschen Versicherungswirt-schaft (DAI-GDV-BDI) 	<ul style="list-style-type: none"> - Deutsche Bundesbank (DBB) - Bundesministerium der Justiz (DE) 	<ul style="list-style-type: none"> - Federation of German Consumer Organisations (VZBV) 	17

			- Deutsche Post DHL (Post) - Bayer AG (Bayer)			
Greece	- Greek CSD (Helex)					1
Hungary				- Hungarian Ministry for National Economy (HU)		1
Ireland						0
Italy		- UniCredit Group (UniCredit) - Stakeholder requested confidentiality (CONF.1) - Italian Banking Association (ABI)		- Italian Ministry of Economy and Finance (IT)		4
Latvia						0
Lithuania						0
Luxembourg		- Luxembourg Bankers' Association (ABBL)				1
Malta						0
Netherlands		- Kas Bank (Kas Bank) - Dutch Advisory Committee Securities Industry (DACSI)		- Dutch Ministry of Finance (NL)		3
Poland	- Polish Central Securities Depository (KDPW)					1
Portugal	- Stakeholder requested confidentiality (CONF.2)					1
Romania	- Romanian Central Securities Depository					1
Slovakia						0
Slovenia						0

Spain	- Bolsas y Mercados Españoles (BME)					1
Sweden		<ul style="list-style-type: none"> - Nordic Securities Association (NSA) - Nordic Financial Unions (NFU) - Svenska Fondhandlare-föreningen (SSDA) 		- Swedish Ministry of Finance (SE)		4
UK	- London Stock Exchange Group plc (LSEG)	<ul style="list-style-type: none"> - Capita Registrars (CR) - UK Payments (Payments) - Stakeholder requested confidentiality (anonymous) 	<ul style="list-style-type: none"> - GC100 Group (GC100) - National Association of Pension Funds (NAPF) - Hermes Equity Ownership Service (HEOS) - Investment Management Association (IMA) - Association of Private Client Investment Managers (APCIMS) - The Institute of Chartered Secretaries and Administrators (ICSA) - Equiniti (Equiniti) - ICSA Registrars Group (ICSA) - Confederation of British Industry (CBI) 	- UK Government (UK)	<ul style="list-style-type: none"> - Company Law Committee of the City of London Law Society (CLLS-CLC) - Financial Markets Law Committee (FMLC) - Financial Law Committee of City of London Law Society (CLLS-FLC) - Pinsent Masons LLP (Pinsent) 	18
Pan-EU	<ul style="list-style-type: none"> - European Central Securities Depositories (ECSDA) - Euroclear (Euroclear) 	<ul style="list-style-type: none"> - European Corporate Governance Service (ECGS) - Association for Financial Markets in 	<ul style="list-style-type: none"> - Euroshareholders (ESH) - ABI-Eumedion-Eurosif - EuropeanIssuers 	- European Central Bank (ECB)		12

		<ul style="list-style-type: none"> - Europe (AFME) - European Savings Banks Group (ESBG) - European Association of Co-operative Banks (EACB) - European Association of Public Banks (EAPB) - European Banking Federation (EBF) 	(EuropeanIssuers)			
Norway				- Ministry of Finance of Norway (NO)		1
USA			<ul style="list-style-type: none"> - ICGN Accounting & Auditing Practices Committee (ECGN) - Computershare Limited (Computershare) 			2
International		<ul style="list-style-type: none"> - International Securities Lending Association (ISLA) - International Capital Market Association Limited (ICMA) - Association of Global Custodians (AGC) 		- Hague Conference of Private International Law (HCCH)	- International Swaps & Derivatives Association (ISDA)	5
TOTAL	13	34	30	15	16	108